

1997

# Rollover of Retirement Plan Distributions: A Proposal to Eliminate the Dual Rollover Structure

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# Rollover of Retirement Plan Distributions: A Proposal to Eliminate the Dual Rollover Structure

BY PETER M. VAN ZANTE\*

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## INTRODUCTION

Generally, when a participant in a tax-qualified retirement plan receives a distribution from that plan, she must include the amount of the distribution in her gross income for federal income tax purposes in the year in which she receives the distribution.<sup>1</sup> However, if

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<sup>1</sup> See I.R.C. § 402(a) (1994). Tax-qualified retirement plans are regulated by two distinct legal regimes. First, provisions of the Internal Revenue Code ("Code") specify the tax treatment of retirement savings. See, e.g., *id.* §§ 401-417, 501. The Code in effect specifies much of the substantive content of an employer-sponsored, tax-qualified retirement plan through its requirements for tax qualification. See, e.g., *id.* § 401(a)(31) (requiring that a tax-qualified

the distributee transfers all or any portion of the distribution to another tax-qualified retirement plan or to an IRA in a valid "rollover" transfer, she may exclude the amount rolled over from gross income.<sup>2</sup> A distributee could roll over her retirement plan distribution in order to avoid current income taxation of the distribution and to preserve the distribution in another tax-qualified retirement savings account. In fact, each year millions of taxpayers receive distributions from retirement plans, and a substantial number of these taxpayers elect to take advantage of the rollover provisions.<sup>3</sup> The rollover rules are important because of their widespread impact, and because the rules enable these distributees to preserve their retirement savings until after actual retirement. The rollover provisions are closely connected with the future retirement income security of employees who receive retirement plan distributions.<sup>4</sup>

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retirement plan provide a distributee with a direct rollover election). In addition, the Employee Retirement Income Security Act of 1974 ("ERISA") creates a broad regulatory framework for employee benefit plans sponsored by employers that provide retirement and other benefits. *See* ERISA, Pub. L. No. 93-406, 88 Stat. 829 (1974). Titles I, III, and IV of ERISA of 1974 are codified as amended at 29 U.S.C. §§ 1001-1461 (1994), and often are cited as ERISA act sections. *See, e.g.*, 2 Pension and Employee Benefits (CCH) § 1 (Jan. 1, 1997). Together, the Code's retirement plan provisions and ERISA comprise the law governing retirement plans.

<sup>2</sup> *See* I.R.C. § 402(c)(1).

<sup>3</sup> As of 1990, there were 712,000 private retirement plans with 77 million participants. *See* CELIA SILVERMAN ET AL., EBRI DATABOOK ON EMPLOYEE BENEFITS 141 (3d ed. 1995). In 1992, the Senate Finance Committee estimated that as many as 16 million individual taxpayers might be affected by the pension distribution taxation rules. *See* SENATE FIN. COMM., 102D CONG., 2D SESS., TECHNICAL EXPLANATION OF THE SENATE FINANCE COMMITTEE AMENDMENT TO H.R. 4210, WITH MINORITY VIEWS 77, at 108-09 (Comm. Print 1992). Between 1987 and 1990, there were 46 million lump-sum total distributions from retirement programs, with almost 11 million distributions in 1990 alone. *See* Paul Yakoboski, *Retirement Program Lump-Sum Distributions: Hundreds of Billions in Hidden Pension Income*, 146 EMPL. BENEFITS RESEARCH INST. ISSUE BRIEF 3 (1994).

<sup>4</sup> *See* SENATE FIN. COMM., 102D CONG., 2D SESS., TECHNICAL EXPLANATION OF THE SENATE FINANCE COMMITTEE AMENDMENT TO H.R. 4210, WITH MINORITY VIEWS 77, at 109 (Comm. Print 1992) ("The single largest source of lost pension benefits is preretirement cashouts of pension savings in lump-sum distributions.").

The first provision permitting the tax-free rollover of a retirement plan distribution was added to the Internal Revenue Code ("Code") by a 1974 amendment<sup>5</sup> enacted as part of the Employee Retirement Income Security Act of 1974 ("ERISA"). The ERISA rollover provision<sup>6</sup> created a two-step process for the rollover transfer: first, a retirement plan distributes accumulated retirement savings to a participant, and second, the participant transfers any portion of that distribution to a successor eligible retirement plan.<sup>7</sup> This Article refers to this form of rollover transfer as an "actual rollover."<sup>8</sup> In 1992, Congress thoroughly overhauled the rollover rules. As part of this revision, Congress added a second form of rollover transfer to the Code, the "direct rollover."<sup>9</sup> Under the direct rollover form of transfer, a retirement plan participant does not receive an actual distribution of her retirement savings. Instead, after the distribution has become distributable to the participant under the provisions of the retirement plan, the participant has a right to direct the retirement plan administrator to transfer all or any part of the distributable amount directly to a participant-designated eligible retirement plan.<sup>10</sup> The direct rollover accomplishes in one step the same transfer that requires two steps in an actual rollover.

Because the Code presently permits a retirement plan participant to transfer her retirement savings by either an actual rollover or a direct rollover, the Code creates complexity in the transfer of retirement savings. The law governing the dual structure is more complex than it would be if there were only a single form of rollover. The dual structure also makes administration and compliance more complex for retirement plan participants and plan administrators. Very little benefit is gained from having two forms for a rollover transfer. This Article analyzes the

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<sup>5</sup> ERISA, Pub. L. No. 93-406, § 2002(g)(5), 88 Stat. 829, 968 (1974) (adding I.R.C. § 402(a)(5)).

<sup>6</sup> *See id.*

<sup>7</sup> *See* I.R.C. § 402(c).

<sup>8</sup> The term "actual rollover" does not appear in the Code or the Treasury Regulations. It is suggested to distinguish the two-step form of rollover from the direct rollover form. *See infra* note 9 and accompanying text. The term "rollover" is used to include both forms of rollover.

<sup>9</sup> *See* Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, §§ 521, 522, 106 Stat. 290, 300, 313 (1992) [hereinafter UCA]. In addition to adding the direct rollover form of transfer, the UCA revised the definition of an eligible rollover distribution to substantially expand its coverage. *See* I.R.C. §§ 401(a)(31), 402(c).

<sup>10</sup> *See* I.R.C. § 401(a)(31); *infra* notes 118-20 and accompanying text.

costs and benefits of the dual rollover structure. It argues that total retirement savings for workers would be increased if there were a single form of a rollover transfer. This Article recommends that Congress eliminate the direct rollover form of rollover transfer, and enact certain improvements to the actual rollover form.

To summarize, income taxation of "retirement savings" is deferred for as long as the savings are held in a tax-qualified retirement savings account. Part I of this Article develops a premise that, to an important extent, the identification of retirement savings is formalistic. Income tax deferral depends solely upon the savings being held in a tax-qualified retirement savings account, and there are only weak connections between that form of holding the savings and their ultimate use to provide retirement income security to the employee. Part I.E focuses closely on retirement plan distribution provisions, and particularly on the prohibition against involuntary cash-out distributions and the important implications this prohibition has on the analysis of the dual rollover structure.

Parts II and III offer a review of the technical requirements for an actual rollover and for a direct rollover, and the consequences to the taxpayer of an unsuccessful attempt to roll over a distribution. An important theme of Parts II and III is the complexity of the law governing rollovers. Superficially, it may seem that the actual rollover transaction is a straightforward two-step transfer process, and that the direct rollover is even more simple. In practice, these seemingly simple concepts spawn a plethora of technical rules. Readers familiar with the rollover provisions may wish to proceed to Part IV

Part IV of the Article develops the conceptual implications of rollover transfers. Part V suggests a conceptual foundation for development of an improved rollover structure, specifically that any retirement plan distribution ought to be subject to rollover to the extent that the distributed retirement savings were qualified for continued holding as tax-qualified retirement savings in the distributing retirement trust. Part VI compares the benefits and costs of the dual rollover structure and concludes that a single form of rollover would result in increased retirement savings for employees. Part VII compares actual and direct rollovers and concludes that the actual rollover should be retained as the sole form of rollover transfer. Part VIII then offers suggestions for improvement of the direct rollover system. A brief conclusion follows.

## I. TAX-QUALIFIED RETIREMENT PLANS AND DISTRIBUTIONS

### A. Retirement Savings

A tax-free rollover is available to a distributee who receives a distribution from a particular type of retirement savings program, which the Code's rollover section describes as a "qualified trust."<sup>11</sup> A qualified trust is a trust created and sponsored by an employer as part of a retirement plan that, together with the retirement plan, satisfies all of the requirements of I.R.C. § 401.<sup>12</sup> So long as the retirement plan and trust

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<sup>11</sup> I.R.C. § 402(c)(8)(A).

<sup>12</sup> See *id.* § 401. The term "qualified trust" is limited to a trust created in connection with a plan that is described in I.R.C. § 401. See *id.* § 402(c)(8)(A). I.R.C. § 402(a) governs taxation of distributions from a plan and trust described in I.R.C. § 401, and I.R.C. § 402(c) permits a rollover of a distribution from this identical category of plans and trusts. In practice, most plans and trusts described in I.R.C. § 401 are sponsored by private, for-profit employers.

In addition to plans and trusts described in I.R.C. § 401, there are other retirement savings programs that provide for tax-deferred savings for retirement and that have their own rollover provisions. I.R.C. § 403(a) defers the taxation of amounts that an employer pays to purchase annuity contracts for the benefit of its employees. See *id.* § 403(a). In general terms, an I.R.C. § 403(a) annuity plan is the virtual equivalent of a qualified trust, except that instead of being funded by a trust, it is funded by annuity contracts issued by an insurance company. I.R.C. § 403(a)(4) provides that distributions from an I.R.C. § 403(a) plan may be rolled over under rules similar to those of I.R.C. § 402(c). See *id.* § 403(a)(4). Because of their virtual equivalency, a distribution from an I.R.C. § 403(a) plan may be rolled over into an I.R.C. § 401 qualified trust, see *id.* § 403(a)(4)(B), and a distribution from a qualified trust may be rolled over into an I.R.C. § 403(a) plan, see *id.* § 402(c)(8)(B)(iv).

An IRA permits an individual to establish for herself an account in which to accumulate retirement savings on a tax-deferred basis. See *id.* § 408. An IRA is not an employee's trust nor a qualified trust. See *id.* § 402(a), (c). Therefore, IRA distributions are not taxed under I.R.C. § 402(a) nor rolled over under I.R.C. § 402(c). IRA distributions are included in gross income as ordinary income under I.R.C. § 408(d) and may be rolled over under special rollover rules applicable only to IRA distributions. See *id.* § 408(d)(3). A rollover of an IRA distribution may be transferred only to another IRA, with the exception that if the distributing IRA has received only contributions that were rollover contributions of distributions from a qualified trust, the rollover may be transferred to a qualified trust. See *id.* § 408(d)(3)(A)(ii).



comply with I.R.C. § 401, they are "qualified" or "tax-qualified," and can be referred to as a "tax-qualified retirement plan and trust," or simply as a "retirement plan."<sup>13</sup>

An employer creates a tax-qualified plan and trust for the purpose of paying retirement benefits and other benefits to certain of its employees. A retirement plan and trust must be created by means of written documents,<sup>14</sup> and the documents will specify which of the employer's employees will be "participants" in the retirement plan.<sup>15</sup> Participation in the plan means that, during an employee's period of employment with the sponsoring employer, she accrues legally enforceable rights to receive retirement and certain other benefits from the retirement trust. During this period of employment, the employer must pay contributions to the

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I.R.C. § 403(b) provides income tax deferral for contributions paid by an employer that is a tax-exempt organization described in I.R.C. § 501(c)(3), an educational organization described in I.R.C. § 170(b)(1)(A)(ii), or a governmental entity. *See id.* § 403(b). I.R.C. § 403(b)(8) includes rollover rules applicable to distributions from these plans. *See id.*

<sup>13</sup> *Id.* § 401. I.R.C. § 401 incorporates by reference the other retirement plan tax qualification requirements found in Part I of subchapter D of the Code. *See generally id.* §§ 401-20. I.R.C. § 401 generally requires that contributions paid pursuant to a tax-qualified retirement plan must be paid to a trust fund that is separate from the employer and maintained as part of the retirement plan. *See id.* § 401(a). This Article refers to a tax-qualified retirement plan and trust together as a "retirement plan." When reference is made to the distribution of retirement savings from a retirement plan, it should be understood that, technically, the retirement trust associated with the retirement plan has made a distribution to a retirement plan participant. There are several species of retirement plans, including pension, profit-sharing, and stock bonus plans. *See* Treas. Reg. § 1.401-1(a) (as amended in 1976).

<sup>14</sup> *See* ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1) (1994).

<sup>15</sup> A "participant" in a retirement plan "means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan" ERISA § 3(7). An employee must become a participant in her employer's retirement plan after the later of her completion of one year of service or her attaining age 21. The one-year-of-service requirement may be extended to two years in the case of plans that provide 100% immediate vesting. *See* I.R.C. § 410(a)(1)(B)(i); ERISA § 202(a)(1)(B)(i), 29 U.S.C. § 1052(a)(1)(B)(i). In addition to the age and years-of-service conditions for plan participation, an employer may restrict participation in a retirement plan to a class of employees, so long as the classification is not discriminatory in favor of highly compensated employees. *See* I.R.C. § 410(b).

retirement trust; those contributions, together with accumulated investment earnings on them, will provide the benefits to which the employee becomes entitled. The retirement trust must hold the contributions and earnings separate from the employer's assets and for the exclusive benefit of the retirement plan participants.<sup>16</sup> The employer's retirement plan document will specify in precise detail when benefits will be paid from the retirement trust to a retirement plan participant. The retirement plan will define certain "triggering events."<sup>17</sup> After a triggering event has occurred, such as the participant retiring from active employment at age sixty-five, a benefit becomes payable to the participant. The retirement plan pays a benefit to the participant by means of distributing to her money or other property from the retirement trust.

Since a retirement plan participant earns rights to receive benefits from her employer's retirement plan through her continued employment with the employer, these rights are a form of the participant's compensation from her employer. The participant receives this compensation in the form of an in-kind right to receive future retirement plan benefits.<sup>18</sup> The portion of a retirement plan participant's compensation that is payable in the form of a benefit from a retirement plan is referred to as "tax-qualified deferred compensation." It is tax-qualified because it is earned and paid through the vehicle of a tax-qualified retirement plan. It is deferred because it is earned during a participant's active employment with the sponsoring employer, but not paid until some future year.<sup>19</sup>

Since the employer must pay contributions to a retirement trust that should be sufficient to pay the benefits promised to the participants, a tax-qualified retirement trust is always a "funded trust." At any given time, it is possible to determine the benefit rights that have accrued to each participant and to place a valuation upon these rights. Furthermore, because the deferred compensation that a participant accumulates in a

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<sup>16</sup> See I.R.C. § 401(a)(2); ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).

<sup>17</sup> See *infra* notes 33-37 and accompanying text.

<sup>18</sup> A participant's right to receive a benefit under the retirement plan is referred to as her "accrued benefit." See ERISA § 3(23).

<sup>19</sup> An example of a lengthy deferral period would be the case of an employee who was employed by a sponsoring-employer at age 25, and who earned a right to receive a retirement benefit payable when she attained age 65. In this case, payment of the participant's compensation in the form of a retirement benefit would be deferred for 40 years. The length of a deferral period depends upon the facts of a specific participant's employment history and upon the triggering provisions of her employer's retirement plan, which determine when and what type of benefits will be paid.

retirement trust represents a portion of her earnings that she has saved through the retirement plan,<sup>20</sup> a participant's savings held by a retirement plan can be referred to as "retirement savings." For each year of active employment during which a participant accrues additional rights to receive benefits from a retirement plan, the participant has, in effect, set aside a portion of her current earnings as retirement savings.

### *B. Identification of Retirement Savings*

The U.S. income tax law includes special provisions that govern the taxation of "retirement savings." Therefore, it is necessary to distinguish retirement savings from other savings a taxpayer might accumulate. In order for savings to be entitled to income taxation under the retirement savings regime, a necessary condition is that the savings be held in a tax-

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<sup>20</sup> When a participant receives compensation in the form of an accumulation of retirement savings in her employer's retirement plan, this form of compensation may affect the amounts of other forms of compensation the participant receives. If a participant accrues rights to retirement savings, she may be paid less compensation in the form of wages and salary currently paid as cash. See RICHARD A. POSNER, *AGING AND OLD AGE* 325 (1995) ("[I]t is now generally accepted that increases in payroll taxes or other labor costs are borne largely by the workers themselves, in the form of reduced wages or benefits."); JOHN H. LANGBEIN & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW* 29 (2d ed. 1995) ("Employees pay for pensions and other fringe benefits in reduced cash compensation."); Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POL'Y 225, 242 & n.57 (1991) ("[E]mpirical research suggests that employees do value deferred compensation promises and are willing to accept reduction in cash wages on account of them.").

In discussing the incidence of the social security payroll tax, which is similar in effect to an employer's contributions to retirement savings held for an employee, Professor McCaffery concludes, "economically, the standard (indeed, nearly universal) assumption is that the entire 15.3% [social security payroll tax] in fact comes out of each employee's paycheck. The reasoning is elementary: The costs to the employer are employee-specific, and thus must come out of salary." Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1878 (1994). Accord Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275, 1279 (1991) ("Thus, for the individual contributor, the Social Security system is just like forced savings: individuals are required to give up consumption now in return for more consumption later.").

qualified retirement plan,<sup>21</sup> an IRA, or certain other forms of retirement savings programs.<sup>22</sup>

On one level, the requirement that retirement savings be held in a tax-qualified retirement plan is a matter of form. In order for savings to be taxed as retirement savings, it is sufficient that the savings be held in a retirement plan. There is no requirement that the participant preserve those savings until she actually retires from active employment, nor any requirement that the retirement savings actually be applied to support the participant or savings owner during her retirement years. Conversely, an individual might accumulate savings outside of a retirement plan that she intends to use to support herself after retirement, and in fact uses for retirement purposes. However, since the savings were not formally held in a retirement plan, they would be subject to the general income tax provisions.

On another level, the fact that retirement savings must be held in a tax-qualified retirement plan imposes substantial and important restrictions upon many aspects of retirement savings. When retirement savings are held in a tax-qualified retirement plan, the holding, investment, and disposition of those savings are all governed by the terms of the retirement plan documents. The legal content of the retirement plan documents is in turn regulated by provisions of the Code, ERISA, and those regulations that implement these statutes. Additions to a taxpayer's retirement savings<sup>23</sup> may be made only from the taxpayer's income earned by the performance of personal services, that is, from compensa-

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<sup>21</sup> Technically, retirement savings "held in a tax-qualified retirement plan" are owned by the trustee of the retirement trust associated with the retirement plan. Certain forms of tax-qualified retirement savings programs substitute a legal structure that is functionally equivalent to a trust arrangement for the holding of the retirement savings by a trustee. The "trust-equivalent" retirement savings programs are annuity plans under I.R.C. § 403(a) and (b).

<sup>22</sup> A tax-qualified retirement plan is described by I.R.C. § 401, and an IRA by I.R.C. § 408. In addition, I.R.C. § 403(a) provides for tax-qualified annuity plans and I.R.C. § 403(b) provides for retirement savings programs sponsored by certain tax-exempt organizations or government entities. In the following analysis, for the purpose of brevity, reference is often made only to retirement savings held by a tax-qualified retirement plan. The reader should understand that generally similar income tax treatment is accorded retirement savings held in an IRA, an I.R.C. § 403(a) plan, or an I.R.C. § 403(b) plan.

<sup>23</sup> Additions to the retirement savings held for an individual are described as contributions to a tax-qualified retirement plan that holds an accrued benefit for the individual as a participant in the plan.

tion or earned income. Once savings have been transferred to a retirement plan, those savings can be transferred back to the participant by means of a distribution from the plan to the participant, but a distribution may be paid from a retirement plan only in circumstances and at times specified by the retirement plan documents. The restrictions upon distributions from a retirement plan may limit the extent to which distributions may be made prior to the participant's retirement from active, full-time employment, and the restrictions may channel distributions toward a participant's retirement period.<sup>24</sup> Thus, the limitations upon retirement savings may operate so that a participant accumulates a portion of her compensation during her working career as retirement savings, and then receives distributions of that accumulated retirement savings during her retirement period.

### C. *Taxation of Retirement Savings*

As mentioned, the special income tax provisions governing retirement savings treat savings held in a tax-qualified retirement plan differently than the income tax system treats savings generally. The general income tax treatment of savings is suggested by the Haig-Simons definition of personal income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."<sup>25</sup> Under this definition, an increase in savings is currently included in the taxpayer's income tax base.

In contrast, retirement savings are not included in the taxpayer's income tax base for so long as the savings are held as identifiable retirement savings, that is, held in a tax-qualified retirement plan. The exclusion from the income tax base for retirement savings is implemented by a trilogy of Code provisions. The employer, which pays the contribution to its retirement trust, is allowed an income tax deduction for the contribution.<sup>26</sup> A participating employee need not include in her gross income any amount attributable to the employer's contribution nor to any

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<sup>24</sup> Certain preretirement distributions may be made only after the participant has consented to receive the distribution. See I.R.C. § 411(a)(11)(A) (1994); *infra* note 44 and accompanying text. Certain "premature distributions" are subject to a special 10% penalty tax. See I.R.C. § 72(t).

<sup>25</sup> HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

<sup>26</sup> See I.R.C. § 404. The deduction is subject to numerous limitations depending upon the type of plan, the level of funding of the plan, and whether the employer contributes to other tax-qualified retirement plans. See *id.*

increase in the value of the participant's vested accrued benefit.<sup>27</sup> And the retirement trust is exempt from income tax, so the investment earnings on the contributions are accumulated tax-free.<sup>28</sup> This exclusion of retirement savings from the income tax base continues as long as the savings are held as identifiable retirement savings.

If retirement savings are distributed to the retirement plan participant for whom the savings are held, the amount of the distribution is included in the distributee's gross income, unless the distributee transfers the distribution to another retirement plan in a tax-free rollover transaction.<sup>29</sup> When the retirement savings are finally distributed from a

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<sup>27</sup> See *id.* § 402(a) ("[A]ny amount actually distributed to any distributee by a [tax-qualified retirement trust] shall be taxable to the distributee, in the taxable year of the distributee in which distributed . . ."). Curiously, the Code does not provide an explicit affirmative statement of the participant's gross income exclusion for the year in which an employer's contribution is added to the retirement trust. Since I.R.C. § 402(a) states that amounts distributed from a tax-qualified trust shall be taxable to the distributee in the year in which distributed, the implication is that amounts contributed to the trust are not taxable to the participants in the year of contribution. This interpretation is confirmed by a regulation: "If an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) . . . , the employee is not required to include such contribution in his income except for the year or years in which such contribution is distributed or made available to him." Treas. Reg. § 1.402(a)-1(a)(1)(i) (as amended in 1994).

The absence from the Code of a direct statement of the exclusion from gross income is probably explained by the historical evolution of the Code provisions. The language currently found in I.R.C. § 402(a) was originally enacted as part of the Revenue Act of 1921, Pub. L. No. 67-98, § 219(f), 42 Stat. 227, 247 (1921). Prior to 1921, taxation of the participant in the year of the employer's contribution to the trust was not a likely alternative, since few trusts provided for vesting of a participant's interest prior to retirement. See CHARLES L. DEARING, *INDUSTRIAL PENSIONS* 73 (1954) (showing that survey data from 1950 found that only 22% of workers in the survey were covered by a pension plan that provided any vesting). Even if a trust provided for preretirement vesting, the tax law had not by then developed a general rule that a vested interest in funded employee benefits was to be included in gross income in the year of vesting. I.R.C. § 83(a) was not enacted until 1969. See Tax Reform Act of 1969, Pub. L. No. 91-172, § 321, 83 Stat. 487, 588-91 (1969).

<sup>28</sup> See I.R.C. § 501. The employer's contributions to the retirement trust cause no tax consequence to the trust.

<sup>29</sup> The Code reads in relevant part:

Except as otherwise provided in this section, any amount actually distributed to any distributee by any employees' trust described in

retirement plan and not subsequently rolled over, the amount of that final distribution is included in the distributee's gross income. The income tax exclusion for retirement savings is terminated by the final distribution from a retirement plan to the participant. In effect, the special income tax treatment of retirement savings is simply a deferral of the taxation of savings held in a tax-qualified retirement plan until the year in which the savings are finally distributed from a retirement plan to the participant.<sup>30</sup>

#### *D. Deferred Income Taxation Encourages Retirement Savings*

The generally accepted explanation for the special income tax treatment accorded to retirement savings is that the income tax deferral enhances the total amount of savings transferred from a worker's years of active employment until the worker's retirement period.<sup>31</sup> Enhancement of savings across decades in the worker's life is thought to be advantageous for the worker and for society.<sup>32</sup> Since the premise of the special income tax treatment of retirement savings is this transfer of savings from early in a worker's life until her retirement period, the legal structure regulating retirement savings should encourage the accumulation of retirement savings during the participant's working years, as well as encourage the preservation of the accumulated retirement savings until a participant's retirement period. Conversely, the retirement savings

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section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72 (relating to annuities).

*Id.* § 402(a).

The inclusion under I.R.C. § 402(a) is calculated under I.R.C. § 72, which allows the distributee to recover tax-free any basis she might have in her interest in her retirement plan. Some retirement plans permit a participant to contribute after-tax amounts to the trust, and such after-tax contributions give the contributing participant basis. *See id.* § 72(f). In addition to the exclusion for an amount rolled over, the amount of unrealized appreciation in employer securities received in certain distributions is not included in the distributee's gross income. *See id.* § 402(e)(4). There is also a deduction allowed for the amount of any lump sum distribution for which the distributee elects the special averaging method for computing the tax. *See id.* § 402(d)(3).

<sup>30</sup> *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1140 (1974) ("The whole matter of qualified pension and profit-sharing plans is primarily one of deferral. ").

<sup>31</sup> *See infra* note 41 and accompanying text.

<sup>32</sup> *See infra* note 42 and accompanying text.

structure should discourage the application of accumulated retirement savings to a participant's consumption expenditures at times prior to her retirement period.

However, the legal structure regulating retirement savings is constrained by a vitally important characteristic of the retirement savings system. Sponsorship of a retirement plan by an employer is voluntary, and additions to retirement savings by individuals also have an important voluntary component. Thus, if the legal structure for retirement savings is perceived by employers and employees as unduly restrictive or burdensome, they will simply opt out of the system. The opportunity for taxpayers to opt out creates a pervasive tension in retirement plan law between provisions that enhance the lifetime retirement savings transfer and provisions that grant employers and employees flexibility so as to encourage their participation in the system.

#### *E. Retirement Plan Distributions*

The laws regulating the distribution provisions of retirement plans reflect the tension between the goal of encouraging the intralife transfer of retirement savings and the need for flexibility so employers and employees can adopt a retirement plan that provides for their specific needs and preferences. If protection of the intralife transfer of retirement savings were the sole goal of the regulation of retirement plan distribution provisions, the only event that would trigger a retirement plan distribution would be the prototypical triggering event of the participant's actual retirement at or after age sixty-five. But in fact, the income tax regulations permit a range of other events to be included as triggering events.<sup>33</sup> Therefore, a distribution may become payable if a participant becomes disabled,<sup>34</sup>

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<sup>33</sup> A pension plan must be established primarily to provide retirement benefits, but it also may provide disability and death benefits. *See* Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 1976). A profit-sharing or stock bonus plan may provide retirement benefits, and it also may provide for distributions to be made to participants "after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment." *Id.* § 1.401-1(b)(1)(ii), (iii).

Of particular significance for this analysis, retirement plans are permitted, but not required, to pay a participant's accrued benefit to her shortly after she has terminated employment with the sponsoring employer. *See id.*, *infra* notes 38-39 and accompanying text.

<sup>34</sup> A distribution made to a participant after her disability may be properly



dies,<sup>35</sup> terminates employment with a particular employer regardless of the employee's age, or, in the case of a profit-sharing plan, after the participant completes a minimum number of years of service with an employer.<sup>36</sup> This range of choice in retirement plan distribution provisions permits employers to design a plan that will most effectively implement the employer's goals in providing tax-qualified benefits to its employees, and which will maximize the perceived value of this form of deferred compensation for its employees.<sup>37</sup> To the extent that a retirement plan more effectively achieves the goals of the employer and provides greater perceived value for the employees, an employer is more likely to sponsor such a program.

### 1. *Preretirement Distributions*

Many employers have determined that a participant's termination of employment should be a triggering event under their retirement plans.<sup>38</sup>

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thought of as a retirement-type distribution. Even though a disability distribution is made before a participant's normal retirement age, it is made at a time when the participant is no longer able to support herself. Thus it is more similar to a retirement-type distribution than a preretirement distribution.

<sup>35</sup> A distribution after the death of a participant does not raise concerns about premature consumption of a participant's retirement savings by the participant herself. Since the participant is deceased, she obviously will have no retirement period during which her retirement savings would be required for her support. However, to the extent a participant's retirement savings are held not only to support the participant during her retirement period, but also to support her spouse, distributions to a spouse before the spouse's normal retirement age do raise the same concerns about premature consumption of retirement savings.

<sup>36</sup> A profit-sharing plan may distribute a participant's retirement savings to her after the employer's contributions to the plan have been accumulated for a fixed number of years. At a minimum, a contribution need be held in a profit-sharing trust for only two years before its distribution. *See* Treas. Reg. § 1.401-1(b)(1)(ii) ("The plan must provide a definite predetermined formula for distributing the funds accumulated under the plan after a fixed number of years. "); Rev. Rul. 54-231, 1954-1 C.B. 150 (permitting an employer contribution that has been held by a profit-sharing trust for two years or more to be distributed); Rev. Rul. 68-24, 1968-1 C.B. 150 (permitting an employer contribution that has been held for less than two years to be withdrawn by a participant with at least 60 months of participation). A profit-sharing plan, including one that includes an I.R.C. § 401(k) cash or deferred arrangement, may make a distribution to a participant at any time during the participant's career based upon financial hardship of the participant.

<sup>37</sup> The employer that sponsors a retirement plan controls the definition of the triggering events under its retirement plan.

<sup>38</sup> Such a provision operates without reference to the age of the participant;

Such a provision often provides that a terminated participant's accrued benefit becomes distributable to her shortly after termination of employment.<sup>39</sup> Since a typical retirement plan participant holds several jobs during her working life, the typical participant will terminate employment from active, full-time employment several times before actual retirement at or after age sixty-five. Thus, a participant's previously accumulated retirement savings may become distributable to her several times during her working life. These distributions early in a participant's working career are referred to as "preretirement distributions."<sup>40</sup>

A preretirement distribution creates particular risks that the participant will not preserve her retirement savings until her retirement period.<sup>41</sup> If

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thus, there is potential for distribution to be made to a participant at a young age, many years before her actual retirement.

<sup>39</sup> This form of distribution is commonly permitted in defined contribution plans and may be permitted in defined benefit plans. In order for any part of a participant's accrued benefit to be distributable to her, the benefit must be "vested." Typically a retirement plan will provide that a participant's accrued benefit becomes vested upon her disability, death, or attainment of a normal retirement age. In addition, retirement plans are required to provide minimum levels of vesting based upon a participant's completion of stated periods of service. Thus, even if a participant terminates employment before actual retirement, she will be entitled to receive the vested portion of her accrued benefit at some time after her termination of employment. One permissible vesting system provides that the participant is completely unvested until she completes two years of service, she is 20% vested upon completion of her third year, and she earns an additional 20% vesting for each of years four through seven, so that she is 100% vested upon completion of her seventh year of service. See I.R.C. § 411(a)(2)(B) (1994); ERISA § 203(a)(2)(B), 29 U.S.C. § 1053(a)(2)(B) (1994).

<sup>40</sup> The term "preretirement distribution" is not technically defined in the Code or Regulations. It is used to describe a distribution paid to a participant because she terminated employment with a particular employer, and paid before the *later* of the participant's attaining age 65 or the participant's actual retirement from active, full-time employment. In general, a preretirement distribution can be thought of as a distribution that a participant receives at an age at which a worker would typically still be able to support herself through active employment.

A distribution other than a preretirement distribution will be referred to as "retirement-type distribution." A retirement-type distribution can be thought of as a distribution that a participant receives at an age when a worker would typically be retired from active employment and would be relying upon her accumulated retirement savings for support.

<sup>41</sup> Preretirement distributions are extremely significant in the analysis of the

the participant fails to transfer the preretirement distribution in a rollover transfer, a portion of the distribution may be applied to payment of income tax liability imposed upon the retirement plan distribution. In addition, when the distributed retirement savings are not rolled over, any portion of the distribution saved by the participant will be saved as regular, currently taxable, savings, and part of the income earned on those savings may be applied toward payment of the income tax liability on that income. Finally, direct possession of the distributed funds may create a temptation for the distributee to apply those funds to immediate consumption spending. These applications of distributed retirement savings toward purposes other than saving for the participant's retirement period result in premature consumption of the retirement savings.

In order to fulfill the intralife transfer objective of the retirement plan system, it is important that preretirement distributions be preserved as retirement savings. If a worker receives several preretirement distributions during her working career and fails to preserve these distributions as retirement savings, she may arrive at her actual retirement with inadequate savings to provide retirement income security for her entire retirement period.<sup>42</sup> Thus, the prevalence of cash-out distributions from retirement plans creates the risk that workers may consume their retirement savings before their retirement years.<sup>43</sup>

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rollover structure. If a worker receives a preretirement distribution and applies that distribution to consumption spending, as opposed to rolling over the distribution and preserving it as retirement savings, the worker risks reaching a typical retirement age with retirement savings that are inadequate to support herself during a typical retirement period. The need for a worker to preserve a preretirement distribution as retirement savings is referred to as the "preservation of retirement savings" issue. Preservation of retirement savings is an important factor in the analysis of the rollover structure. *See infra* Part VII.C.

<sup>42</sup> Premature consumption of retirement savings is a particularly significant problem in the case of preretirement distributions received by a participant early in her working career. When a participant receives a distribution at a young age, her retirement period is further away and she may fail to correctly evaluate her needs for income security so many years in the future. Yet it is exactly the retirement savings accumulated early in a participant's working career that might make the greatest contribution to retirement period security. The reason for this is that those retirement savings could be held across several decades, during which the effect of compounded earnings and riskier investments would result in larger investment accumulations.

<sup>43</sup> *See* SENATE FIN. COMM., 102D CONG., 2D SESS., TECHNICAL EXPLANATION OF THE SENATE FINANCE COMMITTEE AMENDMENT TO H.R. 4210, WITH MINORITY VIEWS 77, at 109 (Comm. Print 1992) ("The single largest source of

Reduction of premature consumption of preretirement distributions is an important policy to be implemented by retirement plan law. Two aspects of retirement plan law specifically address the particular risks to preservation of retirement savings associated with a preretirement distribution. These are the prohibition against involuntary cash-outs and the rollover provisions. The prohibition against involuntary cash-outs is addressed in the following section, and the rollover provisions are addressed in the balance of the Article.

## 2. *Prohibition Against Involuntary Cash-Outs*

The prohibition against involuntary cash-outs forbids an immediate distribution to a participant, without the participant's prior consent, of the present value of the participant's accrued benefit, if the present value exceeds \$5000 and if the distribution would be made before the *later* of a participant's attaining the normal retirement age specified in the retirement plan or her attaining the age of sixty-two (if the specified normal retirement age is lower than age sixty-two).<sup>44</sup> The implications of this prohibition can be understood by considering the context in which it operates. If a triggering event has occurred, so that a participant's accrued benefit has become distributable to her, and if the prohibition applies, the participant's distributable accrued benefit may not be actually distributed to the participant until she has provided the plan administrator with written consent to receive that distribution.<sup>45</sup> Furthermore, the

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lost pension benefits is preretirement cashouts of pension savings in lump-sum distributions.").

<sup>44</sup> See I.R.C. § 411(a)(11) (1994), *amended by* Pub. L. No. 105-34, § 1071(a)(1), 111 Stat. 788, 948 (1997); ERISA § 203(e), *amended by* Pub. L. No. 105-34, 111 Stat. 788, 948 (1997); Treas. Reg. § 1.411(a)-11 (as amended in 1995). If the retirement plan specifies a normal retirement age younger than age 62, the prohibition on involuntary cash-outs continues until the participant has attained age 62. See *id.* § 1.411(a)-11(c)(4). The terminology "involuntary cash-out" does not appear in the Code or ERISA. It describes the types of distributions forbidden by I.R.C. § 411(a)(11) and ERISA § 203(e). See I.R.C. § 411(a)(11); ERISA § 203(e), 29 U.S.C. § 1053(e); Treas. Reg. § 1.411(a)-11 (as amended in 1995). This Article refers to a distribution that may be made only after the participant consents under I.R.C. § 411(a)(11) to a "cash-out distribution." Cf. *id.* § 1.411(a)-11(c)(4) (describing a cash-out distribution as "immediately distributable").

The balance of this Article will assume that any retirement plan referred to specifies a normal retirement age older than 62.

<sup>45</sup> The prohibition forbids only a distribution made without the consent of

participant's consent is not effective unless the plan administrator provides the participant with a full explanation of her right to defer receipt of the distribution and of the relative values of alternative forms of benefits. This explanation is referred to as the "cash-out explanation."<sup>46</sup> This means that in the case of a distributable benefit to which the prohibition applies, the mere occurrence of a triggering event is not sufficient to cause an actual distribution to the participant.

In most cases in which a participant's retirement savings become distributable before a participant attains the later of the age benchmarks, the retirement savings may be actually distributed only after the participant has received the cash-out explanation and has consented to receive the distribution. Because a preretirement distribution<sup>47</sup> may not be made to a participant without the participant's consent, an employer may not unilaterally distribute the current cash value of a participant's accrued benefit to the participant and thereby terminate the participant's further participation in the employer's retirement plan. In effect, a retirement plan participant has a right to leave her retirement savings in a plan sponsored by her (former) employer even though she is no longer

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the participant; if a participant consents to receive a distribution of the present value of her accrued benefit, then she may be "cashed-out" of her retirement plan at any time. *See* I.R.C. § 411(a)(11)(A).

<sup>46</sup> *See* Treas. Reg. § 1.411(a)-11(c)(2). The participant's consent must be in writing, and must be received by the plan administrator not more than 90 days, nor less than 30 days, before the date the distribution commences. However, the 30-day period may be waived if the plan administrator provides information "clearly indicating that the participant has a right to at least 30 days to consider whether to consent to the distribution." Temp. Treas. Reg. § 1.411(a)-11T(c)(2)(iii) (1995).

<sup>47</sup> *See supra* note 40 and accompanying text.

However, these two sets of distributions are approximately congruous, so that the prohibition on involuntary cash-out distributions is approximately equivalent to a prohibition on nonconsensual preretirement distributions. There are two cases in which preretirement distributions are different than the cash-out distributions. First, a preretirement distribution of \$3500 or less may be paid without the participant's consent, and a distribution after a normal retirement age of 62 or older in a case in which the participant remains actively employed does not require consent. Thus, almost all preretirement distributions of more than \$3500 will require the participant's consent, and most importantly, all preretirement distributions of more than \$3500 paid prior to age 62 will require the participant's consent. This last category of distributions of more than \$3500 paid prior to age 62 includes the preretirement distributions for which preservation until the retirement period is most important.

employed by that employer.<sup>48</sup> The prohibition on involuntary cash-out distributions might preserve retirement savings by preventing a retirement plan from thrusting a distribution upon a terminated participant at a time when the participant is unprepared to roll over the distribution, to assume responsibility for its investment, and to preserve it until actual retirement.

Alternatively, the prohibition on involuntary cash-out distributions might have little effect upon the preservation of retirement savings. It clearly gives a terminated participant who intends to preserve her retirement savings another option for her retirement savings account. Namely, in addition to her option to roll over the retirement savings to an IRA, she may leave her retirement savings invested with her employer's retirement plan. However, if the participant is bent upon consuming her retirement savings, the prohibition on involuntary cash-out distributions may have little effect upon her consumption-versus-preservation decision. The participant may receive an actual distribution of her retirement savings simply by consenting to accept the distribution. If consumption of the savings is the participant's goal, a consent that she unilaterally controls poses no impediment to this consumption. In practice, the prohibition on involuntary cash-out distributions may do nothing more than establish a procedure by which a retirement plan participant receives additional information about her distributable accrued benefit and the alternatives that exist for the future disposition of that benefit.

Apart from its implications for preservation of retirement savings, the prohibition on involuntary cash-out distributions has a crucial relationship with the structure of the rollover provisions. Since consent to receive a distribution necessarily precedes that distribution, it follows that the

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<sup>48</sup> A retirement plan may cash-out an accrued benefit that has a present value of \$3500 or less without the participant's consent. This rule protects a retirement plan from the possibly disproportionate administrative costs associated with carrying a small accrued benefit across, potentially, many decades. The balance of the analysis assumes that the participant's accrued benefit has a present value in excess of \$3500.

A retirement plan is forbidden to circumvent the prohibition on involuntary cash-outs. A participant's consent to receive a preretirement distribution "is not valid if a significant detriment is imposed under the plan on any participant who does not consent to a distribution." Treas. Reg. § 1.411(a)-11(c)(2)(i). *Accord* Rev. Rul. 96-47, 1996-40 I.R.B. 7 (holding that Treas. Reg. § 411(a)(11) consent to distribution is not valid if plan provides that terminated participants' accounts are to be invested into a money market fund, when other participants have a broad range of investment choices).

participant's consent to receive the distribution will also always precede the participant's actual rollover or the participant's election of a direct rollover. The context clarifies the relationship: after a triggering event, a participant's vested accrued benefit is distributable. If the participant consents to receive that distributable accrued benefit, then the participant has a right to a "potential distribution."<sup>49</sup> If the participant does not elect a direct rollover, then the potential distribution is actually paid to the participant and it becomes an "actual distribution."<sup>50</sup> If the participant does elect a direct rollover, then the potential distribution is *never* actually paid to the participant but is transferred to another retirement plan or to an IRA.<sup>51</sup> Conceptually and legally, the consent to receive a distribution precedes the direct rollover election, and as a practical matter, the consent and the direct rollover election are part of a single administrative transaction by which a retirement plan participant directs the disposition of her distributable accrued benefit. The crucial relationship is that a participant will always have a legal right to an immediate actual distribution from her retirement plan while she decides whether or not to elect a direct rollover. This relationship has important implications for the comparison of the actual rollover and direct rollover alternatives.<sup>52</sup> However, before comparing the actual rollover and direct rollover alternatives, this Article will analyze the technical requirements of each form of rollover.

## II. ACTUAL ROLLOVERS

An actual rollover permits a qualified retirement plan participant who receives an actual distribution<sup>53</sup> that meets the definition of an "eligible rollover distribution,"<sup>54</sup> to transfer all or any portion of the distribution to an eligible retirement plan. If the rollover transfer complies with all of the requirements for an actual rollover, then the rolled over amount will be excluded from the participant's gross income,<sup>55</sup> and it will be

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<sup>49</sup> This Article uses the term "potential distribution" to describe a distribution which the participant has consented to receive, but which has not been actually distributed to her.

<sup>50</sup> Receipt of an actual distribution means that the participant takes direct and unrestricted possession and control of the distributed money or property.

<sup>51</sup> See *infra* notes 134-35 and accompanying text.

<sup>52</sup> See *infra* Part VII.

<sup>53</sup> See *infra* text accompanying notes 62-64.

<sup>54</sup> See *infra* note 66 and accompanying text.

<sup>55</sup> The Code reads in relevant part:

preserved in the successor retirement plan as retirement savings.<sup>56</sup> The requirements for an actual rollover transfer can be reduced to the following elements.

*A. Actual Rollover Requirements and Steps*

*1. Rollover Explanation*

After a retirement plan participant consents to receive her distributable accrued benefit, she has a right to receive a potential distribution, and can be referred to as a "potential distributee."<sup>57</sup> If a distribution to a potential distributee will be an eligible rollover distribution, then before actually paying out the distribution, the plan administrator is required to provide the potential distributee with an explanation of the provisions of the Code that govern rollovers.<sup>58</sup> The rollover explanation will elucidate

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If —

(A) any portion of the balance to the credit of an employee in a qualified trust is paid to the employee in an eligible rollover distribution,

(B) the distributee transfers any portion of the property received in such distribution to an eligible retirement plan, and

(C) in the case of a distribution other than money, the amount so transferred consists of the property distributed,

then such distribution (to the extent so transferred) shall not be includible in gross income for the taxable year in which paid.

I.R.C. § 402(c)(1) (1994). *See generally* Treas. Reg. §§ 1.401(a)(31)-1, Q&A-1-18, 1.402(c)-2, Q&A-1-16, 1.403(b)-2, Q&A-1-4 (1995); Temp. Treas. Reg. § 1.402(a)(5)-1T, Q&A-1-4 (1986).

<sup>56</sup> *See infra* text accompanying notes 161-64.

<sup>57</sup> This Article uses the term "potential distributee" to refer to a retirement plan participant whose vested accrued benefit has become distributable because of the occurrence of a triggering event, and who has consented to receive that distribution. As a potential distributee, she must elect to have her distributable accrued benefit either transferred in a direct rollover or paid to her in an actual distribution. *See supra* text accompanying notes 50-51.

<sup>58</sup> *See* I.R.C. § 402(f); Treas. Reg. § 1.402(f)-1, Q&A-1 (as amended in 1995). This Article refers to the explanation required by I.R.C. § 402(f) as the "rollover explanation." The rollover explanation is intended to provide a potential distributee with sufficient information to enable her to decide whether to elect a direct rollover or to receive an actual distribution, and having received that actual distribution, whether to retain the distribution or to roll it over in an actual rollover.



the three choices for the potential distributee: election of a direct rollover, receipt of an actual distribution, and rollover of an actual distribution.<sup>59</sup> Legally, the rollover explanation imposes upon the potential distributee the responsibility to choose among these alternatives, and to affirmatively dispose of her distributable accrued benefit.<sup>60</sup> This choice is controlled solely by the potential distributee.<sup>61</sup>

## 2. *A Distributee Actually Receives a Distribution*

If the participant does not elect the direct rollover form of transfer, then she will receive an actual distribution.<sup>62</sup> After the participant

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The IRS has published a "Safe Harbor Explanation" of the rollover provisions. See I.R.S. Notice 92-48, 1992-2 C.B. 377

If a plan administrator provides an appropriately completed Safe Harbor Explanation to a potential distributee, the plan administrator has satisfied its obligations under I.R.C. § 402(f). See *id.* at 378. A plan administrator may satisfy its I.R.C. § 402(f) obligations with an explanation different from the Safe Harbor Explanation, but an alternative explanation "must contain the information required by section 402(f) and must be written in a manner designed to be easily understood." *Id.*

The plan administrator must provide a distributee with the I.R.C. § 402(f) notice

no less than 30 days and no more than 90 days before the date of distribution. However, if the distributee, after having received the section 402(f) notice, affirmatively elects a distribution, a plan will not fail to satisfy section 402(f) merely because the distribution is made less than 30 days after the section 402(f) notice was provided.

Treas. Reg. § 1.402(f)-1, Q&A-2 (as amended in 1995).

<sup>59</sup> See, e.g., I.R.S. Notice 92-48, 92-2 C.B. 377, 378-80.

<sup>60</sup> "[T]he plan administrator may establish a default procedure whereby any distributee who fails to make an affirmative election is treated as having either made or not made a direct rollover election." Treas. Reg. § 1.401(a)(31)-1, Q&A-7 (1995).

<sup>61</sup> Every tax-qualified retirement plan is required by I.R.C. § 401(a)(31), as a condition of qualification, to provide the direct rollover election. I.R.C. § 401(a)(31)(A). See *infra* note 119 and accompanying text.

<sup>62</sup> If the participant elects to have her distributable accrued benefit transferred in a direct rollover to another retirement plan or an IRA, then obviously no actual distribution will be made to her; and without a distribution, a potential distributee has nothing to transfer in an actual rollover. The direct rollover and actual rollover forms of transfer are mutually exclusive as to particular assets. The regulations require that a plan permit a potential distributee

receives that actual distribution, she may either retain the distributed amount or transfer all or any portion of the distribution in an actual rollover transfer. The amount retained by the distributee will be included in gross income; the amount rolled over will be excluded. The actual receipt of a distribution by the distributee creates the factual condition to which the balance of the rollover requirements relate: the distributee has possession of the distributed retirement savings, and if she intends to avoid current income taxation of the distribution, she must comply with the actual rollover rules.

Important characteristics of the actual rollover system follow from the fact that it permits the retirement plan to actually distribute a participant's retirement savings to her. The actual distribution implies that the responsibility for compliance with the rollover requirements rests upon the distributee, and the plan administrator of the distributing plan is not required to have further involvement in the participant's rollover transfer.<sup>63</sup> In addition, after an actual distribution, the distributing plan no longer has any responsibility or legal liability for the participant's retirement savings.<sup>64</sup> The actual distribution clearly and cleanly terminates the relationship between the plan and the distributee.

### 3. *Qualified Trust*

Only a distribution from a "qualified trust" may be rolled over under I.R.C. § 402(c).<sup>65</sup>

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to elect a direct rollover of a portion of her potential distribution. *See* Treas. Reg. § 1.401(a)(31)-1, Q&A-9. As for the balance received in an actual distribution, the distributee may transfer all or any part of that balance in an actual rollover. *See* I.R.C. § 402(c).

<sup>63</sup> This characteristic of the actual rollover system is an important difference between it and the direct rollover system. *See infra* Parts II.A.8 and VII.A.2.

<sup>64</sup> ERISA protects "participants" in an employee benefit plan. *See, e.g.,* ERISA § 404(a)(1), 29 U.S.C. § 1104 (1994) (providing that a retirement plan "fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants"). A "participant" in a retirement plan means "any employee or former employee who is eligible to receive a benefit" from the retirement plan. *Id.* § 3(7), 29 U.S.C. § 1002(7). Thus, after all of a participant's accrued benefit has been distributed to her, she no longer is a participant in the plan, and therefore is no longer protected by ERISA.

<sup>65</sup> I.R.C. § 402(c)(1)(A) ("If any portion of the balance to the credit of an employee in a *qualified trust* is paid to the employee in an eligible rollover distribution" (emphasis added)). "The term 'qualified trust' means an

#### 4. *Eligible Rollover Distribution*

The statutory definition of an “eligible rollover distribution” includes any distribution from a qualified trust to a participant, with the specific exception of two types of distributions;<sup>66</sup> one category of distribution excluded from rollover is generally referred to as “periodic payments,”<sup>67</sup> and the other category is a distribution required by the minimum distribution rules.<sup>68</sup> In addition to these categories excluded by the Code, the regulations contain other exclusions from the eligible rollover distribution definition.<sup>69</sup> Every distribution will be an eligible rollover distribution unless specifically excluded by a statutory exception or a provision of the regulations.

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employees’ trust described in section 401(a) which is exempt from tax under section 501(a).” *Id.* § 402(c)(8)(A). *See supra* note 12 and accompanying text.

<sup>66</sup> The Code reads in relevant part:

[T]he term ‘eligible rollover distribution’ means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust; except that such term shall not include —

(A) any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made

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(i) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee’s designated beneficiary, or

(ii) for a specified period of 10 years or more, and

(B) any distribution to the extent such distribution is required under section 401(a)(9).

I.R.C. § 402(c)(4).

Since the eligible rollover distribution definition repeats the requirement that the distribution must be distributed by a “qualified trust,” distributions from all other retirement savings vehicles are excluded from the eligible rollover distribution category. In other words, a distribution from an IRA or from an I.R.C. § 403 plan is not an eligible rollover distribution. The statute specifically includes distributions of all or any portion of a participant’s balance in her retirement trust; thus, a partial distribution from a retirement trust may be rolled over.

<sup>67</sup> *Id.* § 402(c)(4)(A).

<sup>68</sup> *See id.* § 402(c)(4)(B).

<sup>69</sup> *See* Treas. Reg. § 1.402(c)-2, Q&A-4 (1995).

### 5. *Income Tax Withholding*

The 1992 Unemployment Compensation Amendments to the Code that created the direct rollover system also added a new income tax withholding provision requiring a plan administrator to withhold income tax at a twenty percent rate from any eligible rollover distribution actually distributed to a retirement plan participant.<sup>70</sup> This twenty percent withholding tax is imposed on all eligible rollover distributions that are actually distributed; the withholding tax rate is not adjusted to take into account the participant's expected income tax liability. In particular, twenty percent of an eligible rollover distribution is withheld even in the case in which the distributee intends to actually roll over the distribution.<sup>71</sup> In order for a distributee to roll over the full amount of an eligible rollover distribution that is actually distributed, the distributee must supplement the eighty percent after-withholding-tax portion of the distribution with other funds so that the amount transferred in the actual rollover transfer will equal one hundred percent of the eligible rollover distribution. If the distributee is able to replace the twenty percent of the distribution withheld, then an amount equal to the entire eligible rollover distribution can be rolled over, and hence, the full amount of the eligible rollover distribution may be excluded from the distributee's gross income.<sup>72</sup> If the distributee rolls over only the eighty percent portion of the eligible rollover distribution, then only that eighty percent will be excluded from the distributee's gross income; twenty percent of the eligible rollover distribution amount will be included in gross income.<sup>73</sup>

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<sup>70</sup> See Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 290, 314 (codified as amended in I.R.C. § 3405(c) (1994)).

<sup>71</sup> See I.R.C. § 3405(c). If the participant transferred in an actual rollover transfer an amount equal to the full amount of an eligible rollover distribution from the participant's retirement plan, the entire amount of the distribution would be excludable from gross income, and the distribution would not increase the taxpayer's income tax liability. See *id.* § 402(c)(1). In this case, the 20% withholding tax is, in effect, a prepayment of the distributee's other tax liability; this prepayment is creditable against other tax liability, and any overpayment is refundable.

<sup>72</sup> See *id.* § 402(c)(1).

<sup>73</sup> See *id.* In effect, the 20% withholding tax amount will be subject to income taxation. See *Moon v. United States*, 80 A.F.T.R.2d 97-5390 (Ct. Fed. Cl. 1997) (holding that the 20% withholding tax amount was includable in the distributee's gross income, notwithstanding his intent to roll over the entire distributable amount).

As applied to a distribution that is actually rolled over in full, the twenty percent withholding tax is inappropriate because tax is withheld from a distribution that is wholly excluded from gross income, and which therefore generates no income tax liability.<sup>74</sup> In the case of an actual rollover, the twenty percent withholding tax is a prepayment of a tax that will not be payable.<sup>75</sup>

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<sup>74</sup> As applied in the case of a distributee who receives an actual distribution of an eligible rollover distribution, and who transfers the entire amount of that distribution in an actual rollover transfer, the 20% withholding tax is strongly counterintuitive. The withholding tax is by definition imposed upon an eligible rollover distribution; it is this same definition that describes the distributions subject to rollover, and hence, exclusion from gross income. When the distribution is excluded from gross income, it generates no income tax liability. Thus, the 20% withholding tax is imposed upon the exact category of distributions that may potentially be excluded from gross income. This counterintuitive result occurs because the 20% withholding tax rate is not adjusted to account for the distributee's probable income tax liability attributable to the eligible rollover distribution. Withholding from a distribution that the distributee in fact rolls over implies that, all else being equal, the distributee will have overpaid her income taxes for the year of distribution, and she will be entitled to a refund when she files her tax return.

If a distributee receives an actual distribution of an eligible rollover distribution and does not transfer the entire amount of the distribution in a rollover transfer, then the 20% withholding tax may, or may not, prepay the distributee's tax liability attributable to the actual distribution. In cases in which the distributee does not intend to roll over an eligible rollover distribution, the application of a withholding tax is logical. However, the 20% flat rate is completely arbitrary, and will result in over-withholding by distributees who receive smaller distributions and who do not have other substantial taxable income. A distributee who receives a large distribution, or who has substantial other income, may find the 20% withholding to be insufficient.

In contrast to the flat 20% rate applicable to an eligible rollover distribution, the general withholding system for payments from a retirement plan permits the participant to elect to have no withholding, and withholding from periodic payments is based upon the wage withholding tables, which consider a taxpayer's probable income tax liability. *See id.* § 3405(a).

This Article recommends that the 20% withholding tax be amended to permit the adjustment of withholding depending upon the distributee's probable tax liability on the distribution. *See infra* Part VIII.A.

<sup>75</sup> The 20% withholding tax does not apply to an eligible rollover distribution transferred in a direct rollover. *See* I.R.C. § 3405(c)(2). Consequently, if a potential distributee intends to roll over all or any part of the amount distributable to her, the direct rollover form of transfer will be the preferred

## 6. *The Distributee Must Transfer an Amount*

A tax-free rollover is a two-step transaction: the receipt of a distribution, followed by the transfer of all or any portion of that distribution. In the typical rollover transaction, the distributee receives the distribution and deposits it to some personal financial account. Then, to complete the rollover, the distributee must establish a retirement savings account that is an eligible retirement plan<sup>76</sup> and transfer assets received in the distribution from her personal account to the eligible retirement plan.<sup>77</sup> This transfer is the second step of the rollover transfer.

## 7 *Eligible Retirement Plan*

A tax-free rollover transfer requires that a portion of an eligible rollover distribution be transferred to an "eligible retirement plan"; the eligible retirement plan definition includes a "qualified trust" or an IRA.<sup>78</sup> As a practical matter, a qualified trust will not be an available

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method. Avoidance of the 20% withholding tax eliminates the need for the distributee to supplement the distributable amount with her own funds in order to exclude the full amount transferred in a rollover transfer from the distributee's gross income. *See supra* notes 71-72 and accompanying text.

This means the withholding tax is optional with the distributee, even when she plans to receive an actual distribution of her entire retirement savings. The withholding tax applies only to an eligible rollover distribution, which by definition is a distribution from a qualified trust. *See* I.R.C. § 402(c)(4). A qualified trust is a trust created in connection with an employer-sponsored retirement plan described in I.R.C. § 401(a); this excludes an IRA. *See id.* § 402(c)(8)(A). Therefore, a distribution from an IRA is not subject to the withholding tax. If a qualified trust participant desires to avoid the 20% withholding tax, she may direct that her potential eligible rollover distribution be transferred in a direct rollover to an IRA, and then she may withdraw the assets from the IRA. However, distributions from an IRA do not qualify for taxation under the special averaging method available for a "lump sum distribution" from a qualified plan or an I.R.C. § 403(a) plan. *See id.* § 402(d)(4)(A).

<sup>76</sup> *See infra* note 78 and accompanying text.

<sup>77</sup> *See* I.R.C. § 402(c)(1)(B).

<sup>78</sup> The Code reads in relevant part:

The term "eligible retirement plan" means —

- (i) an individual retirement account described in section 408(a),
  - (ii) an individual retirement annuity described in section 408(b)
- (other than an endowment contract),
- (iii) a qualified trust, and

alternative for the great majority of distributees. A qualified trust is, by definition, sponsored by an employer in conjunction with that employer's retirement plan, and few employer-sponsored plans permit the retirement trust to accept rollover contributions from an employee or participant.<sup>79</sup>

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(iv) an annuity plan described in section 403(a).

*Id.* § 402(c)(8)(B); *see* Treas. Reg. § 1.402(c)-2, Q&A-2 (1995). As used in this definition, "qualified trust" has the meaning assigned by I.R.C. § 402(c)(8)(A), which is the same definition of a qualified trust as is used in the general rollover rule and the eligible rollover distribution definition. *See* I.R.C. § 402(c)(1)(A), (c)(4), (c)(8)(A); *supra* note 65 and accompanying text.

For convenience, references in this Article to a retirement trust or to a qualified trust include an I.R.C. § 403(a) annuity plan, and references to an IRA include an individual retirement annuity.

If a deceased employee's accrued benefit is distributed to her spouse, the spouse may roll over the distribution in the same manner as if the spouse were the employee, but the rollover transfer may be deposited only to an IRA. *See id.* § 402(c)(9). A qualified trust can be an eligible retirement plan with respect to a distribution made by that same trust. In letter ruling 95-05-023, a former employee received a distribution from his former employer's retirement trust, and rolled it over into a IRA that qualified as a conduit IRA. Later the individual was permitted to roll over a distribution from the conduit IRA to his former employer's retirement trust. Priv. Ltr. Rul. 95-05-023 (Nov. 9, 1994); *see generally* Frederick J. Benjamin, Jr. & Nicholas P. Damico, *Qualified Plans — Taxation of Distributions*, 370-2nd Tax Mgmt. (BNA) A-75 (June 24, 1996).

<sup>79</sup> There is no legal requirement that the retirement trust permit plan participants to transfer rollover amounts into the trust. *See* I.R.C. § 401(a)(31)(D) ("[A] qualified trust shall be considered an eligible retirement plan only if it is a defined contribution plan, *the terms of which permit the acceptance of rollover distributions.*" (emphasis added)). The regulations are explicit: "[S]ection 401(a)(31) imposes no requirement that any eligible retirement plan accept rollovers. Thus, a plan can refuse to accept rollovers." Treas. Reg. § 1.401(a)(31)-1, Q&A-13(a).

A 1981 survey investigated the acceptance of rollovers by retirement plans. The survey results were summarized:

[Ninety-three] percent of plans did not accept rollovers. Of the plans accepting rollovers, 96 percent placed the rollovers in individual accounts and 4 percent did not specify how the rollover would be treated. Two percent of defined benefit plans with fewer than 100 participants and 1 percent of plans with 100 or more participants accepted rollovers. Nine percent of defined contribution plans with fewer than 100 participants and 5 percent with 100 or more participants accepted rollovers.

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JOHN A. TURNER ET AL., PENSION POLICY FOR A MOBILE LABOR FORCE 109 (1993) (summarizing DONALD S. GRUBBS, JR., STUDY AND ANALYSIS OF PORTABILITY AND RECIPROCITY IN SINGLE-EMPLOYER PENSION FUNDS, Final report prepared under contract to U.S. Department of Labor (July, 1981)).

Prohibition of the acceptance of rollover contributions is typical, because there is little practical benefit to an employer in permitting such transfers, and there are good reasons for an employer's trust to omit any provision for the acceptance of rollover transfers; acceptance of a rollover transfer imposes on the fiduciaries of the transferee plan a responsibility to verify that the rollover is valid, and the fiduciaries undertake legal liability for the proper management and investment of the rollover amount. *See* ERISA §§ 101-111, 401-515, 29 U.S.C. §§ 1021-31, 1101-44. The employer must balance the benefit to it from permitting newly hired employees to roll over amounts into its plan with the increased administrative costs and the liabilities associated with the acceptance of the rollover transfers.

If a qualified trust accepts a contribution which it believes is a valid rollover of a distribution from another qualified trust, and it later is discovered that the distributing trust was not qualified, continued holding of the contribution could jeopardize continued qualification of the receiving plan. The 1995 regulations address this issue in the case of a direct rollover, providing that if the receiving plan obtains a statement from the distributing plan that the distributing plan had received a determination letter stating that the distributing plan was qualified, then the receiving plan's qualification will not be terminated if it is later learned that the distributing plan was not, in fact, qualified. *Treas. Reg. § 1.401(a)(31)-1, Q&A-13(b)* (1995). In 1996, the IRS proposed amendments to this regulation clarifying the protection accorded a receiving plan which accepts a rollover which later proves to be an "invalid rollover," and extending that protection to a plan which receives an actual rollover. *Prop. Treas. Reg. §§ 1.401(a)(31)-1, Q&A-14, A-14(b)(1), 1.402(c)-2, A-11, 61 Fed. Reg. 49,279* (1996). The 1996 proposal required that the plan administrator of the receiving plan must reasonably conclude that the contribution is a valid rollover contribution, and that if it is later determined that the contribution was an invalid rollover contribution, then the amount of the invalid rollover contribution, plus any earnings, must be distributed to the employee within a reasonable time. *Id.* §§ 1.401(a)(31)-1, A-14(a), 61 Fed. Reg. 49,279, 49,280. Congress weighed in on the topic in the Taxpayer Relief Act of 1997, which directs the IRS to clarify that it is not a necessary condition for protection of the receiving plan that the distributing plan have a determination letter from the IRS confirming the distributing plan's qualification. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1509, 111 Stat. 788, 1068 (1997). This represents a further liberalization of protection for the receiving plan, since the 1995 regulations and the 1996 proposals included in their examples of protected cases the fact that the plan administrator of the distributing plan provided a written statement that the distributing plan had



Because a distributee's opportunities to roll over her eligible rollover distribution into a successor employer's retirement trust are likely to be limited, an IRA provides the more common form of eligible retirement plan into which the distributee may roll over her distribution. Unlike the use of a successor employer's retirement trust as the eligible retirement plan, the availability of an IRA as the eligible retirement plan is controlled by the participant. An individual creates an IRA by establishing a trust account at a bank, a savings and loan association, a mutual fund company, or an insurance company<sup>80</sup> Thus, an IRA is the eligible retirement plan that typically receives the rollover transfer under I.R.C. § 402(c).

#### 8. *Participant's Administrative Responsibilities*

Under the actual rollover form of transfer, the distributee bears all responsibility for compliance with the actual rollover requirements. After the plan administrator of the distributing plan has obtained the participant's consent to receive a distribution and provided the potential distributee with the rollover explanation, and assuming the participant does not elect a direct rollover, the plan administrator may proceed to pay an actual distribution to the participant. From the perspective of the employer that sponsors the distributing retirement plan, payment of an actual distribution to a participant may be a preferred alternative. This payment terminates the relationship between the retirement plan and the participant and relieves the retirement plan of any further liability to that

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obtained a determination letter from the IRS. The Conference Committee Report does not elucidate the statute language. H.R. REP. NO. 105-220, at 756 (1997), *reprinted in* 1997 U.S.C.C.A.N. 1129, 1568. Apparently, Congress wants the IRS to refrain from challenging the qualification of a receiving plan so long as the receiving plan obtains a statement from the distributing plan that the distributing plan is intended to be a qualified plan.

*Cf.* Rev. Rul. 96-48, 1996-40 I.R.B. 4-6 (holding that a participant who is a participant by reason of having made a rollover contribution is excluded from the I.R.C. § 401(a)(4) antidiscrimination testing, the ADP test, the ACP test, and the I.R.C. § 416 minimum contribution requirements).

<sup>80</sup> See I.R.C. § 408(a). The individual may create the IRA unilaterally, subject only to the requirement that the IRA be established with a trustee that is a bank or any other person who will administer the trust in a manner consistent with the requirements of I.R.C. § 408. *Id.* § 408(a)(2). In contrast, a retirement trust must be established by an individual's employer, and is controlled by the employer.

participant. The payment also reduces the plan's future administrative expenses because of the elimination of the participant and her retirement savings from the retirement trust. The effect of the actual distribution is to relieve the employer-sponsored retirement plan of responsibility and liability for the participant's retirement savings.

Since the actual distribution relieves the employer-sponsored plan of future responsibility for the participant's retirement savings, a correlative effect is to shift that responsibility to the participant. Upon receipt of the distribution, the participant is then responsible for interim holding and investment of her distributed funds, identification of an eligible retirement plan, and timely transfer of the correct amount of the distribution to the eligible retirement plan. If the actual distributee desires to roll over her distribution to a qualified trust of a successor employer, she must then determine whether that successor employer sponsors a qualified trust and whether it accepts rollover transfers. She must also confirm that the trust is tax-qualified and determine the terms on which the rollover contribution would be held. If the actual distributee is unable to roll over her distribution to a qualified trust of a successor employer, then she must establish an IRA to receive her rollover. In establishing a rollover IRA, the distributee is fully responsible for the selection of the trustee for the IRA and determining an appropriate investment policy or obtaining appropriate investment management services. After the actual distribution, the participant has the responsibility for the future holding and administration of her retirement savings..

## 9 *Property Distribution*

If the eligible rollover distribution includes property other than money, either the distributed property itself must be transferred to the eligible retirement plan, or the property must be sold and the sale proceeds rolled over.<sup>81</sup> Rollover of distributed property in kind can pose

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<sup>81</sup> This is the effect of the combination of I.R.C. § 402(c)(1)(C) and I.R.C. § 402(c)(6). *See id.* § 402(c). Subparagraph (c)(1)(C) seems to say that if property is received in the eligible rollover distribution, that exact same property must be transferred to the eligible retirement plan. *See id.* However, subparagraph (c)(6) allows the distributee to sell distributed property and roll over the proceeds of that sale. *See id.* Thus, a distributee is not required to roll over distributed property in kind; she may sell the distributed property and roll over the proceeds.

Note that any gain (over the fair market value on distribution) upon sale of distributed property is not recognized to the extent that the proceeds of sale are

a practical problem for some distributees, because the fiduciaries of any eligible retirement plan must agree to accept the transfer of the property. If the eligible retirement plan is an employer-sponsored plan, a rollover of property in kind implies, as a practical matter, that the property must be held in an individually directed account,<sup>82</sup> and all investment results of the rolled over property must be allocated exclusively to that account.<sup>83</sup> This is commonly referred to as an "earmarked investment."<sup>84</sup> The individual account for the rollover contribution and the earmarking of investment results produce additional complexity in the administration of the recipient plan and increase the plan's administrative costs. This complexity and cost increase are added disincentives for the sponsor of a retirement plan to permit receipt of rollover contributions in kind. Thus, it is more likely that a distributee who receives a distribution in kind, and who wishes to roll over that distribution to an employer-sponsored plan,

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rolled over. *See id.* § 402(c)(6)(D). This rule equates a rollover of the proceeds of sale of distributed property with a rollover of the property in kind. If the property were rolled over in kind, its fair market value at the date of contribution to the eligible retirement plan would be irrelevant; in effect, post-distribution appreciation could be rolled over. Since the rule allows the rollover of all proceeds of the sale of appreciated property, the result is the same as the transfer of distributed property in kind.

<sup>82</sup> The property that is transferred in kind must be held in an individually directed account so as to relieve the investment fiduciary of the transferee plan of ERISA fiduciary liability for the investment results of the rolled over property. *See* ERISA §§ 101-111, 401-515, 29 U.S.C. §§ 1021-31, 1101-44.

<sup>83</sup> The investment results of property include income, expenses, and changes in fair market value attributable to the property.

<sup>84</sup> The property must be held for the exclusive benefit of the participant who transferred it because there is no alternative to this treatment of the property. If the property is not held for the exclusive benefit of the contributing participant, then the property must necessarily be held for the benefit of other participants. If the property is held for other participants, then the property contributed in kind in the rollover transfer has, in effect, become simply another portfolio investment of the eligible retirement plan. It would be pure happenstance that a distributee of property received in an eligible rollover distribution would desire to transfer property in kind to an eligible retirement plan that desired to acquire that same property, at that time, for its investment portfolio. Since rolled over property would not normally be acquired at that time by the eligible retirement plan, the eligible retirement plan must either dispose of the property or hold it for the exclusive benefit of the participant who rolled it into the plan.

Special accounting for an earmarked investment itself increases the administrative costs of the eligible retirement plan.

will need to sell the distributed property and roll over the proceeds of that sale.

If the distributee's proposed eligible retirement plan is an IRA, the problems of individual direction of investments and earmarking of investment results are not presented, because an IRA, by definition, is established for only one individual, the owner and creator of the account.<sup>85</sup> However, additional problems confront the fiduciaries of an eligible retirement plan, whether that plan is a retirement trust or an IRA. If the contributed property is not generally traded, it will be difficult for the fiduciaries to comply with their obligation to determine the fair market value of all retirement trust or IRA assets at the end of each year. If the contributed property is not easily liquidated, the fiduciaries must insure that they may distribute the property in kind in payment of benefits due the contributing participant. And finally, the fiduciaries of a retirement trust may have liabilities under ERISA that arise out of holding the property.<sup>86</sup> Thus, rollover of the property in kind to an IRA may not be an alternative that is practically available.

These impediments to the rollover of distributed property in kind imply that in many cases, a retirement plan distributee who has received a distribution in kind will need to sell the distributed property and roll over the sale proceeds. Under the actual rollover form of rollover transfer, the responsibility for the sale of distributed property and the rollover of the proper amount of sale proceeds falls upon the retirement plan participant,<sup>87</sup> and since the actual distribution terminates the responsibility of the plan administrator with respect to the participant and her retirement savings, the plan administrator is relieved of any administrative burdens connected with the liquidation of the property

#### 10. *Maximum Rollover Amount*

The maximum amount that may be rolled over is the portion of the eligible rollover distribution<sup>88</sup> that would be includable in the distribu-

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<sup>85</sup> See I.R.C. § 408(a).

<sup>86</sup> See ERISA §§ 101-111, 401-515, 29 U.S.C. §§ 1021-31, 1104-44.

<sup>87</sup> In contrast, in the case of a direct rollover, the plan administrator of the transferor plan will bear the responsibility for liquidation of the property before the transfer.

<sup>88</sup> Note that the eligible rollover distribution may itself be less than the entire amount of a distribution. The eligible rollover distribution excludes required minimum distribution amounts. See I.R.C. §§ 402(c)(2), (4)(B); *supra* Part II.A.4.

tee's gross income if the distributee does not make a rollover contribution.<sup>89</sup> The portion that would be includable in gross income is that part of the distribution in excess of the distributee's "investment in the contract," that is, the distributee's basis in her interest in the retirement trust.<sup>90</sup> In other words, only the "gain" portion of the distribution may be rolled over, or, conversely, the "basis" portion of the distribution may not be rolled over.<sup>91</sup>

### 11. *Transfer Within Sixty Days*

The Code is clear: rollover treatment "shall not apply to any transfer of a distribution made after the 60th day following the day on which the distributee received the property distributed."<sup>92</sup> An IRS letter ruling has addressed when the sixty-day period begins: "Although physical receipt is not always determinative of receipt for beginning the 60-day rollover period, due to the particular facts set out in [the] ruling request, we conclude that the date you took physical receipt of the stock distribution began the 60-day rollover period."<sup>93</sup> This ruling may suggest

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<sup>89</sup> See I.R.C. § 402(c)(2).

<sup>90</sup> See *id.* § 72(c)(1) and (f).

<sup>91</sup> A distributee acquires basis in her interest in a retirement trust by making contributions to the retirement trust that were after-tax contributions. After-tax contributions mainly occur when a contribution to a retirement trust is included in a participant's gross income in the year it is contributed to the trust. The principal effect of the prohibition on rolling over the basis portion of a distribution is to prevent a distributee from rolling over employee contributions.

If more than the gain portion of a retirement trust distribution were contributed to an eligible retirement plan in an attempted rollover, the excess is not, by definition, a rollover contribution because it would exceed the maximum rollover amount. See *id.* § 402(c)(2). If more than the maximum rollover amount is contributed to a retirement trust or an IRA, there can be costly tax consequences to the transferee trust or IRA, or to the distributee when that excess contribution is distributed from the trust or IRA. See *infra* text accompanying notes 102-11.

<sup>92</sup> I.R.C. § 402(c)(3). If more than one distribution is received by a distributee, the sixty-day period applies to each distribution separately. See Treas. Reg. § 1.402(c)-2, Q&A-11 (1995).

<sup>93</sup> Priv. Ltr. Rul. 88-04-014 (Oct. 27, 1987). The holding that the 60-day period begins upon actual physical receipt of the distribution is an excellent application of the statute. It is completely consistent with the literal language of the statute, and it is clear in application and understandable by taxpayers and their advisors. Of course, such a rule creates some possibility for abuse;

a rule that physical possession of the assets distributed marks the beginning of the sixty-day period. Such a rule would be consistent with the general rule for taxation of retirement trust distributions, which applies to "any amount actually distributed."<sup>94</sup> The sixty-day period ends on the sixtieth day following the receipt of the distribution.<sup>95</sup> Aside from a statutory exception for a "frozen deposit,"<sup>96</sup> the sixty-day period is absolute and there is no relief available to a distributee who misses the deadline.<sup>97</sup>

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therefore, the IRS included the caveat that the rule would not be applied in every case.

<sup>94</sup> I.R.C. § 402(a).

<sup>95</sup> See *id.* § 402(c)(3).

<sup>96</sup> The Code provides the one exception to the 60-day rule: if the amount distributed to the distributee becomes a "frozen deposit," then the rollover period shall not end earlier than ten days after the distributee's deposit ceases to be frozen. See *id.* § 402(c)(7). A frozen deposit is a deposit that may not be withdrawn from a financial institution because of its insolvency or state regulatory action. See *id.* § 402(c)(7)(B).

<sup>97</sup> For example, in a letter ruling the IRS held:

[t]he Code does not provide for relief from taxation where amounts are distributed from a qualified plan but not timely rolled over, as in this situation. Furthermore, the Internal Revenue Service does not have the authority to waive or grant extensions of the statutory 60 day period within which rollovers are permitted.

Priv. Ltr. Rul. 88-15-032 (Jan. 19, 1988).

Some commentators have interpreted *Wood v. Commissioner*, 93 T.C. 114 (1989), as a case in which the Tax Court gave a distributee relief from the 60-day rule. See DIANNE BENNETT ET AL., TAXATION OF DISTRIBUTIONS FROM QUALIFIED PLANS ¶ 17.8[1][a] (Supp. No. 1 1997) ("[T]he 60-day period may not be as absolute as it once was."); Benjamin & Damico, *supra* note 78, at A-77 ("The Tax Court, however, has permitted an extension of the 60-day period where a bookkeeping error occurred through the IRA trustee's mistaken transfer of a portion of the eligible rollover distribution to a non-IRA account."). However, in *Wood* the Tax Court did not relax the 60-day rule. Instead, the Court found as a matter of fact that a retirement plan distributee transferred his rollover amount to the trustee of his rollover IRA within the 60-day period, and that the trustee held the rollover amount subject to the rollover IRA trust instrument from the date of the original transfer to the trustee. See *Wood*, 93 T.C. at 121. *Wood* does not represent any relaxation of the absolute nature of the 60-day rule. Instead the Tax Court was willing to consider evidence beyond the trustee's bookkeeping records, and to hold that the substance of the transaction was that the taxpayer had completed his rollover within the 60-day period.

The sixty-day rule can be best understood in relation to the fact that in an actual rollover transaction, the distributee receives an actual distribution of her retirement savings. Under the general rule governing taxation of a retirement plan distribution, the distributee is taxed upon the amount actually received.<sup>98</sup> The actual receipt of a distribution is presumptively taxable, but the actual rollover provision allows a limited exception to the presumption of taxation. The substantive component of this limited exception requires that the rollover amount be transferred to an eligible retirement plan, thereby insuring that the distributed amount is preserved as retirement savings; the sixty-day rule limits the time period during which the distributee may have direct possession and control of her retirement savings.<sup>99</sup> In effect, the sixty-day rule provides that if retirement savings remain outside a retirement savings account for longer than sixty days, then those savings lose their special character as retirement savings and are irrevocably treated as having been distributed.

## 12. *Rollover Election*

The regulations provide:

In order for a contribution of an eligible rollover distribution to an individual retirement plan to constitute a rollover and, thus, to qualify for current exclusion from gross income, a distributee must elect, at the time the contribution is made, to treat the contribution as a rollover contribution. An election is made by designating to the trustee, issuer, or custodian of the eligible retirement plan that the contribution is a rollover contribution. This election is irrevocable.<sup>100</sup>

In most cases, the distributee will fulfill this election requirement without difficulty<sup>101</sup>

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<sup>98</sup> See I.R.C. § 402(a).

<sup>99</sup> See *id.* § 402(c).

<sup>100</sup> Treas. Reg. § 1.402(c)-2, Q&A-13(a) (1995). *Cf.* Temp. Treas. Reg. § 1.402(a)(5)-1T, Q&A 3 (1986) (explaining that a distributee must elect to treat a partial distribution as a rollover contribution at the time the contribution is made). See generally BENNETT ET AL., *supra* note 97, at ¶ 17.8[4]; Benjamin & Damico, *supra* note 78, at A-77

<sup>101</sup> Most rollover transfers are made to IRAs. An IRA is typically offered by a financial institution, which is likely to have standardized documents that require a designation that a contribution is either a rollover contribution or a contribution subject to the current year's contribution limitations. See I.R.C. § 408(a)(1).

### *B. Noncompliance with Actual Rollover Requirements*

If a retirement plan participant who receives an actual distribution desires to roll over all or any portion of that distribution, she must perfect compliance with all of the rollover requirements within the sixty-day rollover period. The first and obvious effect of a failure to roll over a distribution is that the full amount of the original distribution must be included in the distributee's gross income.<sup>102</sup> Beyond this income

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When the distributee completes this document in connection with the creation of a rollover IRA, she also will satisfy the rollover election requirement. If a rollover transfer is made to a qualified trust, the trustee must determine the reason for acceptance of the contribution, and this necessarily implies collecting the information that the contribution is a rollover contribution. In addition, a qualified trust must determine that the contribution is a rollover contribution in order to properly administer the transferred assets.

<sup>102</sup> See *id.* § 402(a). In addition, the I.R.C. § 72(t) 10% tax on early distributions may apply. See *id.* § 72(t). There are a limited number of cases that address rollovers. See *Frank v. Aaronson*, 120 F.3d 10 (2d Cir. 1997) (holding the direct rollover provisions do not create a right in a participant to receive a distribution that was not permitted under the terms of the employer's plan); *Fraser v. Lintas: Campbell-Ewald*, 56 F.3d 722 (6th Cir.) (holding that former participant was not entitled to money damages when administrator failed to provide the rollover explanation, and plaintiff failed to correctly roll over lump sum distribution), *cert. denied*, 116 S. Ct. 477 (1995); *Reliance Ins. Co. v. Zeigler*, 938 F.2d 781, 784 n.4 (7th Cir. 1991) ("A direct transfer of money may be good practice. "); *Gunther v. United States*, 573 F. Supp. 126 (W.D. Mich. 1982) (holding that the deceased distributee's personal representative may roll over a distribution received by the distributee prior to his death); *Rodon v. Commissioner*, 105 T.C. 29 (1995) (holding invalid an attempted rollover by the distributee's soon-to-be ex-wife); *Fazi v. Commissioner*, 102 T.C. 695 (1994) (holding that the entire amount received in a distribution from a then-disqualified plan is subject to ordinary income taxation, and no part qualifies for a rollover); *Wood v. Commissioner*, 93 T.C. 114 (1989) (holding that the taxpayer timely rolled over a distribution by delivering it to his IRA trustee, notwithstanding discrepancies in the trustee's bookkeeping records); *Welander v. Commissioner*, 92 T.C. 866 (1989) (holding that year of taxability is the year of receipt, not the year in which 60-day rollover period expires); *Doing v. Commissioner*, 58 T.C. 115 (1972) (disregarding an apparent distribution to a retirement plan participant, and holding that in substance there was a transfer of funds between plan trustees); *Barnes v. Commissioner*, 67 T.C.M. (CCH) 2341 (1994) (holding that taxpayer's rollover election was irrevocable); *Luke v. Commissioner*, 66 T.C.M. (CCH) 615 (1993) (holding that the taxpayer did not complete a rollover by investing her retirement plan distribution in her personal residence and by paying



taxation of the original distribution, the failure of an attempted rollover transfer has another, perhaps more fundamental consequence. Since the distributee's distribution was not successfully rolled over, this portion of the distributee's savings have permanently lost their identification as retirement savings, and because the savings no longer qualify as retirement savings, they may not be held in a tax-qualified recipient plan or an IRA. Consequently, there is no further deferral of income taxation of the savings and the income they earn.

Assuming that the participant has actually, but erroneously, transferred a putative rollover amount to an eligible retirement plan, the eligible retirement plan is holding a contribution that does not qualify as a rollover contribution, and which does not qualify to be held by a retirement savings account. For example, if a retirement plan distributee contributed to an IRA an amount in excess of the maximum rollover amount, that excess amount constitutes an "excess contribution" to the IRA.<sup>103</sup> So long as an IRA holds an excess contribution, it is subject to an annual six percent excise tax on the amount of the excess contribution.<sup>104</sup> The effect of this tax is to substantially reduce the (otherwise tax-exempt) income the IRA accumulates. In order to eliminate the continuing burden of this excise tax, the owner of the IRA should withdraw the excess contribution. In this manner, the excise tax should

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down her mortgage); *Michel v. Commissioner*, 58 T.C.M. (CCH) 1019 (1989) (holding an invalid rollover deposit into an IRA subject to excise tax); *Tassinari v. Commissioner*, 48 T.C.M. (CCH) 915 (1984), *aff'd*, 774 F.2d 1148 (1st Cir. 1985) (holding that the taxpayer did not roll over a distribution when he invested proceeds of plan distribution in certificates of deposit that were issued to taxpayer personally, rather than to a plan trustee); *Handy v. Commissioner*, 42 T.C.M. (CCH) 593 (1981) (holding that taxpayer's rollover was not timely); *Smiths v. Commissioner*, 42 T.C.M. (CCH) 1638 (1981) (same).

In addition, changes to the Maryland Employees Retirement System and distributions that resulted from those changes have spawned a jurisprudence of their own. *See, e.g.*, *Adler v. Commissioner*, 86 F.3d 378 (4th Cir. 1996); *Campbell v. Commissioner*, 108 T.C. 54 (1997); *Wittstadt v. Commissioner*, 74 T.C.M. (CCH) 396 (1997). These cases construe the pre-1992 requirement that certain distributions could be rolled over only if they were paid "on account of the employee's separation from the service" of the employer. I.R.C. § 402(e)(4)(A)(iii) (West 1990) (amended by the UCA, Pub. L. No. 102-318, § 521(a), 106 Stat. 290, 300 (1992)).

<sup>103</sup> I.R.C. § 4973(b) (1994).

<sup>104</sup> *See id.* § 4973(a).

prevent an IRA from holding assets that do not qualify as retirement savings.<sup>105</sup>

If the excess contribution is distributed to the IRA owner by the due date (including extensions of time) for filing the owner's individual income tax return for the year in which the excess contribution was paid to the IRA, the distribution of the excess contribution need not be included in the distributee's gross income.<sup>106</sup> If an excess contribution to an IRA is not distributed by the owner's individual tax return due date, and assuming that the excess contribution results from the contribution of an amount in excess of a valid rollover amount, the Code includes a special relief provision.<sup>107</sup> If a distributee relied upon information included in a tax information reporting form supplied to her by an employer, retirement trust trustee, or financial institution to determine the amount of the attempted rollover, and it is later discovered that the third-party information was erroneous, then the relief provision is available to the extent that the excess contribution is attributable to that erroneous information. Under the relief provision, the excess contribution may be distributed to the IRA owner, and that distribution is not includable in the owner's gross income.<sup>108</sup> The tax cost will be the six percent tax for those years during which the IRA held the excess contribution.<sup>109</sup>

If the relief provision based upon erroneous third-party information is not available, and if the excess contribution is not corrected by the owner's individual tax return filing due date, the consequences resulting

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<sup>105</sup> If a putative rollover amount were erroneously transferred to a tax-qualified retirement plan, the trustee of the plan would be obligated to return the erroneous contribution to the contributing participant as soon as the error was discovered. A plan is authorized only to accept a rollover contribution that satisfies the rollover requirements, so the erroneous contribution would not constitute a rollover contribution, and it could not be held by the plan. In addition, a contribution in excess of the maximum permitted rollover contribution might violate the I.R.C. § 415 limitations; I.R.C. § 415(c)(2) provides that "annual additions" to a participant's account do not include rollover contributions (as defined in I.R.C. § 402(c)). *Id.* § 415(c)(2). A violation of the I.R.C. § 415 limitations can result in disqualification of the retirement plan. *See id.* § 401(a)(16).

<sup>106</sup> *See id.* § 408(d)(4). In this case, the distribution of the excess contribution must include the earnings on the excess contribution for the period during which the excess contribution was held by the IRA. *See id.* § 408(d)(4)(c).

<sup>107</sup> *See id.* § 408(d)(5)(B).

<sup>108</sup> *See id.* § 408(d)(5).

<sup>109</sup> *See supra* note 103 and accompanying text.

from an erroneous rollover to an IRA can be catastrophic. The original distribution, in effect, is subject to double taxation. Since the distributee's original rollover contribution was invalid, her original retirement plan distribution must be included in her gross income in the year the distribution was received.<sup>110</sup> So long as the excess rollover contribution remains in the IRA, it attracts the special six percent tax, so that its income earning potential is substantially impaired.<sup>111</sup> If the owner decides to distribute the excess contribution to avoid the six percent tax, neither of the provisions of I.R.C. § 408 that exclude IRA corrective distributions from gross income will be available. Thus, the amount of the distribution is (again) included in the owner's gross income upon distribution.<sup>112</sup> This causes full double taxation of the original distribution that the distributee attempted to roll over. In addition, if the distributee were under age 59½, it is likely that the ten percent penalty tax on an early distribution would apply to the distribution from the IRA.<sup>113</sup> This punitive result apparently reflects a very strong policy to limit IRA contributions to valid rollover amounts.

If a retirement plan distributee fails to perfect a rollover transfer, the effect of the unintended tax consequences may be to divert a substantial portion of the distributee's retirement savings from the distributee to the Treasury. This perverse result creates the need for either an alternative to, or improvements in, the actual rollover system.

### III. DIRECT ROLLOVERS

A direct rollover transaction is the transfer of a participant's retirement savings from her current tax-qualified retirement trust to another eligible retirement plan in a single step; the assets are transferred by the trustee of her current qualified trust directly to the eligible retirement plan.<sup>114</sup> Contrast this with an actual rollover transaction,

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<sup>110</sup> See I.R.C. § 402(a). In addition there is the potential for imposition of the 10% tax on an early distribution. See *id.* § 72(t).

<sup>111</sup> See *id.* § 4973(a).

<sup>112</sup> See *id.* § 408(d)(1). Even though the IRA distribution represents an amount previously included in income, the IRA owner has no basis in her IRA attributable to the contribution of that amount. Thus, the entire IRA distribution is included in gross income.

<sup>113</sup> See *id.* § 72(t). See generally Benjamin & Damico, *supra* note 78, at A-76(1), A-78(1), A-85 (Dec. 11, 1995).

<sup>114</sup> The Code reads in relevant part:

which requires two steps: the distribution from a qualified trust to the distributee, followed by a transfer by the distributee to an eligible retirement plan.<sup>115</sup> The direct rollover provisions build upon the definitions and rules that apply to actual rollovers. A direct rollover transfer involves the following elements.

*A. Direct Rollover Requirements and Steps*

*1. Potential Eligible Rollover Distribution*

If a participant has consented to receive a distribution of her benefit from her employer's retirement plan, she has a right to a potential distribution.<sup>116</sup> If that potential distribution would constitute an eligible rollover distribution if it were actually distributed to the potential distributee,<sup>117</sup> the potential distribution can be referred to as a "potential eligible rollover distribution."<sup>118</sup> If a potential distributee is entitled to

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A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that if the distributee of any eligible rollover distribution —

(i) elects to have such distribution paid directly to an eligible retirement plan, and

(ii) specifies the eligible retirement plan to which such distribution is to be paid (in such form and at such time as the plan administrator may prescribe),

such distribution shall be made in the form of a direct trustee-to-trustee transfer to the eligible retirement plan so specified.

I.R.C. § 401(a)(31)(A). *See generally* Treas. Reg. § 1.401(a)(31)-1, Q&A-1-18 (1995).

The Code designates the transaction as a "direct trustee-to-trustee transfer." I.R.C. § 401(a)(31)(A). The regulations have subsequently renamed it a "direct rollover." Treas. Reg. § 1.401(a)(31)-1, Q&A-3.

<sup>115</sup> *See supra* note 77 and accompanying text.

<sup>116</sup> *See supra* note 49 and accompanying text.

<sup>117</sup> For purposes of the direct rollover election, the definition of an eligible rollover distribution is the same as the definition for actual rollover purposes. The direct rollover provision incorporates the eligible rollover distribution definition with references to the actual rollover rules. *See* I.R.C. §§ 401(a)(31)(C), 402(c), 402(f)(2)(A) (1994); Treas. Reg. §§ 1.401(a)(31)-1, Q&A-1, 1.402(c)-2, Q&A-2 (1995).

<sup>118</sup> This Article refers to the "potential distributee" of a "potential eligible rollover distribution." The potential distributee is the retirement trust participant who is entitled to receive a currently payable distribution. The potential eligible

receive a potential eligible rollover distribution, the plan administrator will provide the potential distributee with a rollover explanation.<sup>119</sup> This rollover explanation provides the potential distributee with the information necessary to choose among her alternative courses of action.

## 2. Participant's Election

The rollover explanation describes a potential distributee's right to elect a direct rollover of her potential eligible rollover distribution. If the potential distributee exercises her right to elect a direct rollover, her currently payable accrued benefit will be transferred directly to an eligible retirement plan.<sup>120</sup> A participant has this right to elect a direct rollover

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rollover distribution is a retirement trust benefit that is currently payable, and which, *if actually distributed*, would satisfy the definition of an eligible rollover distribution. This terminology is used to emphasize the essence of the direct rollover transaction: if the potential distributee elects a direct rollover of her potential eligible rollover distribution, no actual distribution will be paid to the potential distributee. Instead, the assets that are payable are transferred directly to an eligible retirement plan.

Contrast this terminology with that of I.R.C. § 401(a)(31)(A), which refers to the "distributee" of an "eligible rollover distribution" electing to have the distribution made in the form of a direct rollover. I.R.C. § 401(a)(31)(A). The essential purpose of the direct rollover transaction is to avoid an actual distribution being made to a plan participant. *See id.* Thus, it is awkward to refer to the "distributee" of a distribution that is never made. Similarly, the definition of an "eligible rollover distribution" requires that a distribution of any portion of the participant's interest in a qualified trust be made to a participant. *Id.* § 402(c)(4). Technically, there cannot be an eligible rollover distribution without a distribution, and the direct rollover negates the possibility of an actual distribution. Notwithstanding its infelicitous language, it is clear that I.R.C. § 401(a)(31)(A) is intended to give a potential distributee the right to elect a direct rollover of a potential eligible rollover distribution, which *if actually distributed* would meet the definition of an eligible rollover distribution.

<sup>119</sup> The conditions that create the I.R.C. § 401(a)(31)(A) direct rollover election right in the participant are the same conditions that trigger the plan administrator's obligation under I.R.C. § 402(f) to provide a rollover explanation. *See id.* §§ 401(a)(31)(A), 402(f); *see supra* note 58 and accompanying text.

<sup>120</sup> *See* I.R.C. § 401(a)(31)(A); *see, e.g.,* I.R.S. Notice 92-48, 1992-2 C.B. 377. The regulations describe the election requirement: "the plan must give the distributee the option of having his or her distribution paid in a direct rollover to an eligible retirement plan specified by the distributee." Treas. Reg. § 1.401(a)(31)-1, Q&A-1. The potential distributee exercises her option to

transfer because every retirement plan is required, as a condition of tax qualification, to provide the direct rollover election.<sup>121</sup> The direct rollover election may relate to a portion of a potential eligible rollover distribution, with the balance of the distribution being paid to the distributee as an actual distribution.<sup>122</sup>

### 3. *Eligible Retirement Plan*

The potential distributee who desires to have her retirement savings transferred in a direct rollover bears the responsibility for identifying an appropriate eligible retirement plan and confirming that the eligible retirement plan will accept the direct rollover.<sup>123</sup> The most common

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receive or to transfer an eligible rollover distribution by filing an election document with a representative of the retirement plan. "[T]he plan administrator may establish a default procedure whereby any distributee who fails to make an affirmative election is treated as having either made or not made a direct rollover election." *Id.*, Q&A-7

<sup>121</sup> See I.R.C. § 401(a)(31)(A). Note that choosing to transfer the potential eligible rollover distribution in a direct rollover is conceptually an election separate from the election of rollover treatment. *Cf. supra* note 100 and accompanying text. However, the regulations provide that choosing a direct rollover transfer also will serve as an election of rollover treatment, at least for transfers to an IRA. See Treas. Reg. § 1.402(c)-2, Q&A-13(b) (1995).

If the participant receives a distribution of a "plan loan offset amount," no direct rollover election need be provided. A plan loan offset amount is distributed to a participant when "under the plan terms governing a plan loan, the participant's accrued benefit is reduced (offset) in order to repay the loan (including the enforcement of the plan's security interest in a participant's accrued benefit)." *Id.*, Q&A-9(b).

<sup>122</sup> See Treas. Reg. § 1.401(a)(31)-1, Q&A-9. The regulations provide that if the potential distributee elects to divide her potential eligible rollover distribution between a direct rollover amount and a distribution amount, the plan administrator of the transferring plan may require that the direct rollover amount be a specified minimum amount, so long as the plan administrator does not specify a minimum in excess of \$500. See *id.* The regulations also provide a de minimus rule; a direct rollover election need not be provided to a potential distributee who is entitled to receive eligible rollover distributions totaling less than \$200 in a year. See *id.*, Q&A-11.

<sup>123</sup> For purposes of the direct rollover election, "the term 'eligible retirement plan' has the meaning given such term by section 402(c)(8)(B), except that a qualified trust shall be considered an eligible retirement plan only if it is a defined contribution plan, the terms of which permit the acceptance of rollover

choice will be an IRA the participant establishes in order to receive the direct rollover, but an employer-sponsored plan may also be the recipient plan.<sup>124</sup> The regulations permit the plan administrator, as a condition of completing the direct rollover, to require the potential distributee to provide sufficient information about the eligible retirement plan to enable the plan administrator to accomplish the direct rollover.<sup>125</sup>

#### 4. *No Income Tax Withholding*

A very important difference between an actual rollover and a direct rollover is the fact that retirement savings transferred in a direct rollover are thereby exempt from the twenty percent withholding tax that would apply if those retirement savings were distributed in an actual distribu-

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distributions." I.R.C. § 401(a)(31)(D). This adjustment in the eligible retirement plan definition means that the participant's *right* to elect a direct rollover does not include a direct rollover to a defined benefit plan. However, this limitation on the election right is of little or no practical significance. Few employer-sponsored plans permit the acceptance of direct rollovers, *see supra* note 79, so the most likely eligible retirement plan to be designated by a participant will be an IRA. The modification of the eligible retirement plan definition does not relate to the IRA branch of the definition.

Even if a participant were to desire to transfer her potential eligible rollover distribution to an employer-sponsored plan, it is improbable that a defined benefit plan would permit the acceptance of a direct rollover. Because a defined benefit plan promises to pay a certain future retirement benefit to a participant, the participant's addition of a rollover contribution would not fit into the benefit structure of the plan. If a defined benefit plan did accept a rollover contribution, it would most likely hold the contribution in a separate, earmarked rollover account for the participant. Such a separate account might well constitute a defined contribution plan for purposes of the direct rollover election. In the unlikely case that a defined benefit plan were designated as an eligible retirement plan, the regulations make explicit that the transferring plan may make a direct rollover to a defined benefit plan that permits the acceptance of rollover contributions. *See* Treas. Reg. § 1.401(a)(31)-1, Q&A-2.

<sup>124</sup> *See supra* note 80 and accompanying text. A "plan administrator is not required (but is permitted) to allow" direct rollover transfers to more than one recipient eligible retirement plan. Treas. Reg. § 1.401(a)(31)-1, Q&A-10.

<sup>125</sup> The potential distributee provides the plan administrator of her retirement trust with information identifying her designated recipient eligible retirement plan and other information sufficient to enable the plan administrator to complete the direct rollover. *See* Treas. Reg. §§ 1.401(a)(31)-1, Q&A-6, 31.3405(c)-1, Q&A-

tion.<sup>126</sup> The exemption of amounts transferred in a direct rollover from the twenty percent withholding tax creates two advantages for the direct rollover form of transfer, as compared with the actual rollover. First, with a direct rollover, none of the potential eligible rollover distribution is applied to payment of the withholding tax; one hundred percent of the distributable amount that the potential distributee elects to directly roll over is transferred to the designated eligible retirement plan, and therefore this full amount may be excluded from the potential distributee's gross income.<sup>127</sup> In contrast, if the distributee receives an actual distribution as the first step in an actual rollover transfer, the distributee must replace the twenty percent of the distribution that has been paid as withholding tax with her own funds in order to roll over an amount equal to one hundred percent of the eligible rollover distribution.<sup>128</sup> Thus, a direct rollover permits the potential distributee to exclude the entire transferred amount from gross income without any further payment or other action by her.<sup>129</sup>

The second advantage of the exemption of the direct rollover from the twenty percent withholding tax is simply the exemption itself. As noted above, as applied to a distribution the distributee actually rolls over, the twenty percent withholding tax is inappropriate, since it is a withholding tax applied to a distribution that is itself excluded from gross income, and which therefore generates no income tax liability.<sup>130</sup> In the case of an actual rollover, the twenty percent withholding tax is a prepayment of a tax that will not be owed. The exemption of the direct rollover from the twenty percent withholding tax avoids possible (temporary) overpayment of the potential distributee's income tax for the year of distribution. The exemption of a direct rollover from the twenty percent withholding tax is a sufficient reason for a potential distributee to elect a direct rollover transfer, rather than choosing to receive an actual distribution and transferring the distributed amount in an actual rollover.

However, the withholding tax exemption comes at the price of substantial administrative responsibilities for both the plan administrator and the potential distributee. The regulations require the plan administrator of the transferring plan to establish a documented basis for transferring a direct rollover that will be exempt from the twenty percent

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<sup>126</sup> See I.R.C. § 3405(c)(2).

<sup>127</sup> See *id.* § 402(e)(6).

<sup>128</sup> See *supra* note 72 and accompanying text.

<sup>129</sup> See I.R.C. § 402(e)(6).

<sup>130</sup> See *supra* note 74 and accompanying text.



withholding tax.<sup>131</sup> The plan administrator of the transferring plan must obtain from the potential distributee information adequate to justify the plan administrator's failure to apply the twenty percent withholding tax to the amount transferred in the direct rollover, including a representation that the recipient plan is an individual retirement plan, a qualified plan, or an I.R.C. § 403(b) annuity. The plan administrator must also obtain information sufficient to permit the plan administrator to actually

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<sup>131</sup> The plan administrator of the transferring plan must obtain from the potential distributee "adequate information" about the transferee plan in order to protect the transferring plan from liability for taxes, interest, or penalties for failure to withhold the 20% withholding tax under I.R.C. § 3405(c). Treas. Reg. § 31.3405(c)-1, Q&A-7(a); I.R.C. § 3405(c).

The plan administrator has obtained from the distributee adequate information . . . if the distributee furnishes to the plan administrator: the name of the eligible retirement plan; a representation that the recipient plan is an individual retirement plan, a qualified plan, or a § 403(b) annuity, as appropriate; and any other information that is necessary in order to permit the plan administrator to accomplish the direct rollover by the means it has selected. This information must include any information needed to comply with the specific requirements of § 1.401(a)(31)-1, Q&A-3 and Q&A-4 of this chapter.

Treas. Reg. § 31.3405(c)-1, Q&A-7(b) (1995). The requirements of Treas. Reg. § 1.401(a)(31)-1, Q&A-3, 4 may include the name and address of the trustee of the eligible retirement plan, or information sufficient to complete a wire transfer to the trustee's bank account. *See id.* § 1.401(a)(31)-1, Q&A-3, 4.

Treas. Reg. § 1.401(a)(31)-1, Q&A-6, permits the plan administrator of a transferring plan to prescribe any reasonable procedure for a distributee to elect a direct rollover under I.R.C. § 401(a)(31).

The procedure may include any reasonable requirement for information or documentation from the distributee in addition to the items of adequate information specified in § 31.3405(c)-1(b), Q&A-7 of this chapter. For example, it would be reasonable for the plan administrator to require that the distributee provide a statement from the designated recipient plan that the plan will accept the direct rollover for the benefit of the distributee and that the recipient plan is, or is intended to be, an individual retirement account, an individual retirement annuity, a qualified annuity plan described in § 403(a), or a qualified trust described in § 401(a), as applicable. In the case of a designated recipient plan that is a qualified trust, it also would be reasonable for the plan administrator to require a statement that the qualified trust is not excepted from the definition of an eligible retirement plan by § 401(a)(31)(D) (i.e., is not a defined benefit plan).

*Id.*, Q&A-6.

implement the direct rollover transfer.<sup>132</sup> In addition to the information the transferring plan administrator must collect from the potential distributee, that plan administrator may collect additional information such as a statement from the recipient plan that it will accept the direct rollover.<sup>133</sup>

The direct rollover system requires significant involvement of the plan administrator in the direct rollover transfer. The information required in order for the plan administrator to actually transfer the participant's retirement savings, in addition to the documentation required by the regulations in order to support the exemption from the twenty percent withholding tax, cause the plan administrator to substantially verify that the participant's proposed direct rollover will in fact comply with the rollover requirements. In effect, the plan administrator must act as an auditor of the participant's proposed direct rollover transfer. Thus, a participant's proposed rollover transaction is individually scrutinized before it is executed, and this scrutiny is performed by a plan administrator who presumably has some degree of expertise in compliance with the rollover requirements. This scrutiny by the plan administrator should enhance the certainty that a participant's rollover transfer complies with the rollover requirements.

#### 5. *Plan Administrator's Direct Transfer*

After receipt of adequate information and documentation from the potential distributee, the plan administrator must transfer the assets comprising the potential eligible rollover distribution directly to the designated eligible retirement plan. The regulations are flexible about the means by which the direct rollover amount is actually transferred. The plan administrator may simply send a check to the recipient eligible retirement plan.<sup>134</sup> Alternatively, the plan administrator may provide the potential distributee with a check and instruct her to deliver the check to the eligible retirement plan; in this case the check must be payable to the trustee of the eligible retirement plan.<sup>135</sup> If an employer chooses the latter pattern for administration of direct rollover transfers, the only difference in the means of transfer between an actual rollover and a direct rollover would be that in an actual rollover, the distributee is the payee

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<sup>132</sup> See Treas. Reg. § 1.401(a)(31)-1, Q&A-6.

<sup>133</sup> See *id.*

<sup>134</sup> See *id.*, Q&A-3.

<sup>135</sup> See *id.*

on the distribution check, while in a direct rollover, the trustee of the eligible retirement plan is the payee of that check.

#### 6. *No Actual Distribution*

The essential element that distinguishes a direct rollover transfer from an actual rollover is the fact that when the potential distributee's retirement savings are transferred in a direct rollover, there is no actual distribution paid to the potential distributee.<sup>136</sup> This elimination of the actual distribution is the linchpin of the direct rollover system. The general rule of taxation of a distribution from a retirement plan is stated in I.R.C. § 402(a): "[A]ny amount *actually distributed* to any distributee by any [retirement trust] shall be taxable to the distributee, in the taxable year of the distributee in which distributed."<sup>137</sup> Since the Code requires that an amount be "actually distributed" to a distributee in order for the distributee to be taxable upon the distribution, elimination of the actual distribution would seem to imply that the direct rollover system eliminates all risk of taxation of a distributable amount transferred in a direct rollover.<sup>138</sup> Thus, in a direct rollover transfer that proceeds according to the statutory and regulatory requirements, there will be no distribution to the potential distributee, and no income tax consequence to the potential distributee from the transfer.<sup>139</sup>

#### 7 *No Sixty-Day Limitation*

In the case of an actual rollover, I.R.C. § 402(c)(3) requires that the distributee transfer the rollover amount within sixty days after the *distributee's receipt of the distribution*.<sup>140</sup> By its terms, this time limit cannot apply to a direct rollover since the distributee never receives a

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<sup>136</sup> In a direct rollover, the eligible rollover distribution must not be paid to, nor made available to, the potential distributee. *See id.*

<sup>137</sup> I.R.C. § 402(a) (1994) (emphasis added).

<sup>138</sup> The result seems to follow from the structure of I.R.C. § 402(a); nonetheless, the UCA included a further amendment to the Code that makes explicit that any amount transferred in a direct rollover is not includable in the potential distributee's gross income. *See id.* § 402(e)(6); *accord* Treas. Reg. § 1.401(a)(31)-1, Q&A-5.

<sup>139</sup> In cases in which a direct rollover does not proceed in accordance with all requirements, the implications of the elimination of the actual distribution are less clear. *See infra* note 149 and accompanying text.

<sup>140</sup> *See* I.R.C. § 402(c)(3).

distribution. Since the direct rollover is a one-step transfer, directly from the transferring plan to the receiving plan, in a normal transaction there should be little delay between disbursement by the transferring plan and receipt by the receiving plan.<sup>141</sup> So long as a direct rollover proceeds in normal fashion, the period for completion of the transfer will be unimportant.<sup>142</sup>

### 8. *Maximum Amount, Election of Rollover Treatment*

The maximum amount which may be transferred in a direct rollover is the amount that would be includable in gross income if it were not transferred;<sup>143</sup> this is equivalent to the maximum amount that may be transferred in an actual rollover.<sup>144</sup> Finally, the requirement that the potential distributee elect rollover treatment applies equally to both an actual rollover and a direct rollover; however, the regulations provide that the election of a direct rollover also is deemed to be an election of rollover treatment.<sup>145</sup>

#### *B. Direct Rollover Equated with Actual Rollover for Qualification Purposes*

By definition, a direct rollover requires that assets be transferred directly from the transferor plan to the recipient plan. In spite of this reality, for retirement plan qualification purposes, the direct rollover transaction is treated as though it were an actual distribution followed by a valid rollover to the eligible retirement plan.<sup>146</sup> This means, for

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<sup>141</sup> See Treas. Reg. § 1.401(a)(31)-1, Q&A-3 ("Reasonable means of direct payment include, for example, a wire transfer or the mailing of a check to the eligible retirement plan."). If the transfer were effected by means of an electronic funds transfer, the transfer and receipt could be nearly simultaneous, or if a check were mailed, the transfer should be a matter of days.

<sup>142</sup> If a direct rollover transfer somehow goes astray, it is unclear what time limitations, if any, should apply to actions taken to correct the transfer.

<sup>143</sup> See I.R.C. § 401(a)(31)(B).

<sup>144</sup> See *id.* § 402(c)(2); *supra* note 89 and accompanying text.

<sup>145</sup> "If an eligible rollover distribution is paid to an individual retirement plan in a direct rollover at the election of the distributee, the distributee is deemed to have irrevocably designated that the direct rollover is a rollover contribution." Treas. Reg. § 1.402(c)-2, Q&A-13(b).

<sup>146</sup> See *id.* § 1.401(a)(31)-1, Q&A-14 ("For purposes of applying the plan qualification requirements of § 401(a), a direct rollover is a distribution and

example, that if an actual distribution to the potential distributee would have required the distributee's consent, that same consent must be obtained before the plan administrator may complete a direct rollover, or if the participant's spouse's consent would have been required before a distribution, his consent is required prior to a direct rollover.<sup>147</sup> A further implication of this characterization of the direct rollover is that the direct transfer of the potential eligible rollover distribution to the recipient plan is not treated as a transfer of assets that invokes the protections relating to a merger of two retirement trusts.<sup>148</sup> Thus, the direct rollover has plan qualification consequences equivalent to those which follow from an actual distribution to a participant, followed by the participant's transfer of a rollover amount to an eligible retirement plan.

### *C. Noncompliance with Direct Rollover Requirements*

If a participant intends to have her distributable retirement savings transferred in a direct rollover, but the direct rollover is not executed in conformity with the governing law and regulations, the tax consequences are unclear.<sup>149</sup> A transaction that the potential distributee or plan administrator intends to accomplish as a direct rollover, but that is not properly completed, is referred to as an "attempted direct rollover."<sup>150</sup>

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rollover of the eligible rollover distribution and not a transfer of assets and liabilities.").

<sup>147</sup> See *id.* A participant must consent prior to the distribution of any benefit having a present value in excess of \$3500. See I.R.C. § 411(a)(11). A participant's spouse must consent to certain distributions. See *id.* §§ 401(a)(11), 417(a)(2).

<sup>148</sup> See Treas. Reg. § 1.401(a)(31)-1, Q&A-14. In the case of a merger of two retirement trusts, each participant must have an accrued benefit in the surviving trust equal to or greater than the benefit to which she would have been entitled in the transferor trust. See I.R.C. § 414(l). This distinction is illustrated in Rev. Rul. 94-76, 1994-2 C.B. 46 (holding that amounts transferred in a direct rollover need not be subject to the same restrictions that applied in the transferor plan).

<sup>149</sup> The direct rollover provisions were enacted in 1992. See *supra* note 9 and accompanying text. To date, there is no reported authority addressing the consequences of a failed direct rollover.

<sup>150</sup> As plan administrators and participants operate under the direct rollover system, because of the large numbers of plans and participants, it is inevitable that some direct rollovers will fail to comply with applicable law and regulations. As of 1990, there were 712,000 private retirement plans with 77 million participants. See SILVERMAN ET AL., *supra* note 3. Between 1987 and 1990, there were 46 million lump-sum total distributions from retirement programs, with

There are three categories into which attempted direct rollover transactions might be sorted.

1. *Participant's Failure to Properly Elect a Direct Rollover*

The first category includes a transaction in which the potential distributee intends to elect a direct rollover, but she fails to complete the election process in a timely fashion, or the election is defective. If the retirement plan's default provision calls for a direct rollover to be completed by the plan administrator when the participant fails to effectively elect the form of rollover, then this fault will not lead to any harm to the participant.<sup>151</sup> However, if the plan's default provision calls for an actual distribution to be made when no effective election is made by a participant, the consequences of the ineffective election depend on what further actions the participant takes. If the participant transfers the distributed retirement savings in an actual rollover within sixty days of its receipt, then the attempted direct rollover will cause only limited harm, or perhaps no harm, to the participant.<sup>152</sup> If the participant fails to perfect an actual rollover within the sixty-day period, the apparent result under existing law is that the entire amount "actually distributed" must be included in the participant's gross income, which in most cases will cause a portion of the participant's distributed retirement savings to be paid to the Treasury as income tax.<sup>153</sup> In all cases, since the retire-

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almost 11 million distributions in 1990 alone. See Yakoboski, *supra* note 3. The 46 million lump sum total distributions figure refers to a category of distributions narrower than the eligible rollover distribution category. Thus, there will be an even larger number of distributions subject to the direct rollover election.

<sup>151</sup> In order for a direct rollover to be completed in the absence of a completed election, the retirement plan document would have to authorize the plan administrator to establish an eligible retirement plan on behalf of the participant and transfer the participant's benefit to that plan. Such a default transfer would not impose any tax liability on the participant, although the identity of the eligible retirement plan might be different than that which the participant would have chosen had she acted.

<sup>152</sup> The actual distribution is subject to the 20% withholding tax; if the participant does not supplement the rollover amount to replace the 20% withheld, her retirement savings after the actual rollover will be only 80% of their predistribution amount. If the participant is able to replace the withheld amount, she will suffer no loss from the attempted direct rollover. See *supra* note 72 and accompanying text.

<sup>153</sup> See I.R.C. § 402(a).

ment savings have not been transferred to another retirement savings account, the savings have been permanently foreclosed from identification as retirement savings in the future.<sup>154</sup>

Perhaps a participant who receives a distribution that she intended to transfer in a direct rollover might be able to avoid these apparent tax consequences by returning the distribution to the distributing retirement plan.<sup>155</sup> However, there is no authority to support the repayment of a retirement plan distribution, so it is unlikely that a retirement plan administrator would agree to accept such a payment. In addition, it seems that the statute clearly requires the participant to include the distribution in her gross income when an amount has been "actually distributed."<sup>156</sup> However, depending upon the facts, the actual distributee might be able to mount a sympathetic case, emphasizing equities such as her intention to elect a direct rollover, which was frustrated by factors beyond her control, or her reasonable failure to effectively elect a direct rollover because of the complexity of the retirement plan distribution and rollover transactions, explanations, and alternatives. The essential factual element supporting relief for the participant in this situation would be that she had no intent to receive a distribution. A court might reasonably conclude that the absence of intent to receive a distribution would constitute a sufficient factual justification for overcoming the statutory language referencing the fact that an amount has been "actually distributed." If a court were willing to conclude that such an unintended distribution could be disregarded and the participant could repay her distributed retirement savings to her retirement plan, the direct rollover would be properly completed.

## *2. Plan Administrator's Failure to Properly Complete a Direct Rollover*

A second category includes a case in which the potential distributee properly elects a direct rollover, but her retirement plan administrator erroneously pays an actual distribution to the participant. This situation is similar to the first type of case, since the actual distributee does not intend to receive a distribution; however, in this situation, the failure of the direct rollover is caused by actions of the plan administrator, rather

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<sup>154</sup> See *supra* text accompanying notes 21-24.

<sup>155</sup> This analysis assumes that the return of the distribution occurs more than sixty days after its receipt.

<sup>156</sup> See I.R.C. § 402(a).

than by the actions of the participant. Again, the apparent conclusion under the literal terms of the statute is that the amount "actually distributed" must be included in the actual distributee's gross income.<sup>157</sup> However, since responsibility for the failure to complete the direct rollover lies with the plan administrator, the participant's equities are stronger, and this case presents a more appealing situation for judicial relief from the statutory language.

### 3. *Disbursements to Someone Other than the Participant*

A third category includes a transaction in which the potential distributee elects a direct rollover and the plan administrator transfers her retirement savings, but the transfer is never completed, or the transfer is made to an account that is not an eligible retirement plan. For example, if a participant elects a direct rollover and her plan administrator transfers her retirement savings to her designated recipient plan, but then it later develops that the recipient plan was not tax-qualified, there has not been a transfer to an eligible retirement plan. Thus, this transfer does not meet the definition of a direct rollover. The issues raised by such a failed direct rollover are whether the disbursement of the participant's retirement savings in such a failed rollover causes the amount disbursed to be included in the participant's gross income, and what impact the failed rollover has upon the identification of the transferred amount as retirement savings.

An assumption of this analysis is that the participant does not gain direct control over the amount disbursed from her retirement plan, nor is the amount transferred to an account directly controlled or owned by the participant.<sup>158</sup> Given this assumption, the transfer may simply not be subject to inclusion in the participant's gross income. I.R.C. § 402(a) requires that an amount be "actually distributed to any distributee."<sup>159</sup> When the participant has not gained control over her retirement savings, there has been no distribution to her as a distributee. Therefore, there is no basis for application of I.R.C. § 402(a), and the amount disbursed is not includable in the participant's gross income.

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<sup>157</sup> See *id.*

<sup>158</sup> If the participant does control the transferred amount, then in substance this form of failed direct rollover is equivalent to an actual distribution to the participant, and the analysis applicable to the preceding two categories will govern the result.

<sup>159</sup> I.R.C. § 402(a).



The second question, the impact of the failed direct rollover upon the identification of the transferred amount as retirement savings, has no obvious answer. The fundamental requirement of retirement savings taxation is that retirement savings must be identified; the identification is accomplished by means of holding the savings in a tax-qualified retirement savings account. In the case of an actual rollover, this fundamental requirement is relaxed so that an actual distribution may be held by the participant outside of a retirement savings account, but only for the limited sixty-day rollover period.<sup>160</sup> The sixty-day rule is not applicable to a direct rollover.<sup>161</sup> Does this mean that funds transferred in a failed direct rollover may be held in an account that is not a tax-qualified retirement savings account for an indefinite period? If so, when it is eventually discovered that the direct rollover has not been successfully completed, can the transferred retirement savings be returned to the transferor plan and resume their status as tax-qualified retirement savings? Since the absence of an actual distribution negates inclusion of the transferred retirement savings in the participant's gross income, apparently these questions may be answered affirmatively.<sup>162</sup> Thus, a failed direct rollover may have no effect upon the participant's retirement savings.

#### IV EFFECTS OF ROLLOVERS

##### A. *Tax Law Creates the Rollover Transaction*<sup>163</sup>

The provisions of the Code that govern the taxation of a rollover transfer may at first appear to be devoted exclusively to the income tax treatment of the transfer. However, the Code provisions do more than simply exempt a rollover transfer from current income taxation; in fact, the tax law creates the rollover transaction and provides the substantive and administrative rules that govern it. The substantive restrictions on a rollover transfer limit the amount,<sup>164</sup> and possibly the

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<sup>160</sup> See *supra* note 92 and accompanying text.

<sup>161</sup> See *supra* text accompanying notes 140-42.

<sup>162</sup> Income earned while the transferred amount is held outside a tax-qualified retirement savings account is apparently not exempt from income taxation under I.R.C. § 501(a), which applies only to a tax-qualified retirement trust. This raises the issue of the proper taxpayer for such income.

<sup>163</sup> In the following discussion, the term "rollover" is used to refer to both forms of rollover transfer.

<sup>164</sup> The rollover rules limit the amount of a participant's retirement savings

composition,<sup>165</sup> of a distributee's retirement savings that may be transferred to another form of retirement savings account. This limitation on the amount that may be rolled over is not simply a limitation on the amount that may be excluded from gross income for purposes of the income tax computation. Rather, it is more fundamentally an absolute limitation on the amount of retirement savings assets that may be transferred to a successor eligible retirement plan to be held in the future as retirement savings.<sup>166</sup>

The rollover provisions also control the administration of a rollover transfer. If the participant elects a direct rollover, the plan administrator of the transferor qualified trust must collect sufficient information about the identity and qualified status of the recipient plan. Then, the currently distributable amount must be transferred to the recipient plan by means that comply with the rollover regulations.<sup>167</sup> If the participant chooses an actual rollover, she must transfer a properly computed rollover amount to the recipient plan within sixty days of receipt of her distribution, and she must elect rollover treatment. In both cases, the fiduciary of the eligible retirement plan will require evidence that the amount transferred is in fact a valid rollover contribution. The rollover rules govern the extent to which, and the manner by which, retirement savings are transferred between two retirement savings accounts.

### *B. Continuation of Income Tax Deferral*

A participant who desires to transfer her retirement savings from a qualified trust to another form of retirement savings account would

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that may be transferred to a successor eligible retirement plan to the amount of a distribution that would be includable in gross income. *See* I.R.C. § 402(c)(2). The effect of this limitation is to forbid a distributee from rolling over the portion of a distribution equal to the amount of her employee contributions (her after-tax contributions). *See supra* note 91 and accompanying text.

<sup>165</sup> If the distribution includes property other than money, that same property, or money in an amount not exceeding the proceeds of the sale of that property, must be transferred to the eligible retirement plan. *See supra* text accompanying notes 81-88.

<sup>166</sup> This limitation on the amount that may be held as retirement savings is implemented by restrictions on the acceptance of rollover contributions by a qualified trust and by the excess contributions provisions applicable to an IRA. *See supra* note 91 and accompanying text.

<sup>167</sup> *See supra* notes 131-33 and accompanying text.

prefer to accomplish the transfer in a manner that continues the income tax deferral enjoyed by retirement savings. Continued income tax deferral implies two elements: first, the retirement savings transferred must not be taxable, and second, the future earnings on the savings must not be subject to current income taxation. The rollover provisions permit a participant to achieve these goals.<sup>168</sup> The first element in continued income tax deferral is the exclusion from gross income provided for amounts transferred in a valid rollover transfer.<sup>169</sup> The second element results from the requirement that, for a valid rollover transfer, the rollover amount must be deposited into an eligible retirement plan. An eligible retirement plan is by definition a form of account exempt from current income taxation.<sup>170</sup> Thus, a transfer to an eligible retirement plan implies continued income tax deferral for the future earnings of the participant's retirement savings.

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<sup>168</sup> In fact, there are at least two other conceptually distinct methods of transferring retirement savings assets from one retirement trust to another retirement trust without income tax being imposed upon the amount transferred. The older of these methods is the plan-to-plan transfer; it requires a direct transfer from one tax-qualified retirement plan to another. Typically these transfers occur in connection with a merger or other change affecting the employer sponsoring the transferring plan. *See, e.g.,* Rev. Rul. 68-160, 68-1 C.B. 167; Rev. Rul. 67-213, 67-2 C.B. 149; Rev. Rul. 55-368, 55-1 C.B. 40. A plan-to-plan transfer can be understood as a merger of all or part of the assets and liabilities of the transferring plan with the assets and liabilities of the receiving plan. The Code does not specifically address the mechanics of a plan-to-plan transfer or merger, but I.R.C. § 414(l) requires that a participant's accrued benefit cannot be reduced as a consequence of a plan merger. *See* I.R.C. § 414(l) (1994); *see generally* BENNETT ET AL., *supra* note 97, ¶¶ 18.1-.5.

The second method of tax-free transfer of retirement savings assets from one plan to another is the elective transfer. This method combines the transfer elements of a plan-to-plan transfer with the concept of a deemed distribution to, and rollover by, the participant pursuant to the participant's election to have her benefits transferred; the deemed distribution followed by a rollover permits the elimination of benefit rights and options that existed in the transferring plan. *See* Treas. Reg. § 1.411(d)-4, Q&A-3(b) (as amended in 1994); *see generally* BENNETT ET AL., *supra* note 97, ¶ 18.3.

<sup>169</sup> *See* I.R.C. § 402(c)(1), (e)(6); *see also* Treas. Reg. § 1.401(a)(31)-1, Q&A-5 (1995). Comparable exclusions are provided for I.R.C. § 403(a) retirement plans, *see* I.R.C. § 403(a)(5), and I.R.C. § 403(b) plans, *see id.* § 403(b)(10).

<sup>170</sup> *See* I.R.C. § 402(c)(8)(B).

C. *Participant Gains Control over Continuation of Income Tax Deferral*

A rollover transfer has an additional consequence for the participant and for her retirement savings that, after the transfer, are held in an eligible retirement plan. The transferred savings will be distributed from the recipient plan in accordance with the provisions of that plan's governing documents. If the recipient eligible retirement plan is an IRA, the rollover amount will be currently withdrawable by the owner of the IRA.<sup>171</sup> If the recipient plan is a qualified trust, it is likely that the plan document will allow the rollover contribution to be withdrawn upon the request of the contributing participant. The right of the IRA owner or plan participant to withdraw her rolled-over savings enables the participant to control the timing of the distribution of the rolled-over assets, and therefore the timing of the inclusion of the retirement savings in the participant's gross income. Thus, an additional consequence of a rollover transfer is to give the participant the power to continue, or to terminate, the deferral of income taxation of her retirement savings.<sup>172</sup>

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<sup>171</sup> The Code imposes no limitation on the rights of the owner of an IRA to withdraw the assets from the IRA. *See id.* § 408. "An IRA owner almost always may withdraw the IRA's funds upon demand (subject to any contractual penalties the trustee, custodian or annuity issuer may impose)." David Rhett Baker, *IRAs and SEPs*, 355-4th Tax Mgmt. (BNA) A-23 (May 26, 1997). Compare I.R.C. § 408(k)(4), which specifically requires that an IRA established in connection with an employer's "simplified employee pension" plan allow the owner of the IRA to freely withdraw amounts contributed to the IRA. I.R.C. § 408(k)(4). Of course, if the owner withdraws an amount from the IRA, that withdrawal may be an "early distribution" subject to the 10% tax on early distributions. *Id.* § 72(t).

<sup>172</sup> The participant's right to control the continued deferral of income taxation of her retirement savings is subject to the limits imposed by the minimum distribution rules. *See* I.R.C. § 401(a)(9). The minimum distribution rules impose a limit on the deferral of taxation of retirement savings. After a participant attains the age of 70½, distribution to her of her retirement savings must begin. In each year beginning with the required beginning date, the minimum required distribution must be made to the participant. Each minimum required distribution must be included in the distributee's gross income; ultimately, the deferral of income taxation of the retirement savings must terminate as the minimum required distributions are paid to the distributee.

## V LIMITS FOR TAX-FREE ROLLOVERS

A. *Pension Portability*

The deepest foundation upon which both the direct and actual rollover provisions rest is the general public policy favoring "pension portability." In its most general sense, pension portability refers to a system that permits an employee to "take her pension with her" when she changes employment. Pension portability is believed to be beneficial social policy because it may promote retirement plan sponsorship by employers, it reduces losses of pension benefits associated with job changing,<sup>173</sup> and it contributes to the mobility of labor, which is believed to have positive economic benefits. A review of the policy of pension portability provides a framework in which to evaluate the rollover provisions.

Pension portability is a protean policy<sup>174</sup> used to justify many aspects of retirement plan law.<sup>175</sup> Perhaps the clearest application of portability policy is the legal requirement that a participant in a qualified trust acquire a vested right to her retirement benefits upon completion of a certain period of service with the employer sponsoring her retirement plan.<sup>176</sup> Vesting is clearly a necessary condition for pension portability; if the participant's right to retirement benefits is not vested, there will be nothing for her to take with her upon termination of employment. However, the portability policy that supports vesting of a right to a retirement benefit does not necessarily imply that the assets held to fund

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<sup>173</sup> See TURNER ET AL., *supra* note 79, at 4.

<sup>174</sup> "Pension portability has been defined as the capacity to carry pension benefits from one job to the next. Pension portability is achieved in three ways: through portability of benefits, service, or assets." *Id.* at 6. The "three components of portability are: (1) portability of benefits, (2) portability of credited service, and (3) portability of current values (cash distributions)." Emily S. Andrews, *Pension Portability and What It Can Do for Retirement Income: A Simulation Approach*, 65 EMPL. BENEFITS RESEARCH INST. ISSUE BRIEF 3 (1987).

<sup>175</sup> Among the statutory provisions that contribute to pension portability are those limiting the eligibility periods that a new employee must satisfy before beginning participation in a tax-qualified retirement plan and those setting out the requirements for vesting in retirement benefits. See I.R.C. §§ 410, 411, ERISA §§ 202, 203, 29 U.S.C. §§ 1052, 1053 (1994).

<sup>176</sup> See I.R.C. § 411, ERISA § 203, 29 U.S.C. 1053; *supra* note 39 and accompanying text.

that retirement benefit ought to be transferable, that is, that there ought to be a system for rolling over retirement savings. Vesting of a right to receive a pension in the future, and the transferability of the assets held to fund that pension, are two separate issues. It would be entirely feasible to have a retirement plan system that mandated vesting but made no provision for the transfer of the assets held to fund those vested benefits.

However, when Congress enacted the first statutory vesting requirements,<sup>177</sup> it coupled those requirements with the first rollover provisions.<sup>178</sup> The rollover provisions are a natural complement to these vesting provisions, because swifter and increased vesting implies that a greater number of participants will become vested in benefits accrued under employer-sponsored retirement plans. This also increases the possibility, if a participant has had several employers, that she will have vested accrued benefits under the plans of several employers. In this situation, a participant may prefer to have her retirement savings held in a single retirement savings account, rather than in retirement trusts maintained by several former employers. Consolidation of a participant's retirement savings in a qualified trust maintained by a current employer, or in an IRA created by the participant, permits the participant to monitor her savings more efficiently and may provide her with additional control over her retirement savings. Consolidation of a participant's retirement savings requires that those savings must be portable. Thus, the creation of more vested accrued benefits owed to more participants created a need for a system that permits the transfer of the assets held to fund those vested benefits to other retirement savings accounts.

Transfer of assets held to fund the vested accrued benefits of a terminated participant may also serve the interests of the employer sponsoring a retirement plan and the interests of the other participants in the plan. Mandated vesting implies that smaller vested accrued benefits will be held for a larger number of participants, and possibly for lengthy periods of time. Holding small vested accrued benefits imposes additional administrative costs on the retirement plan. In order to minimize the administrative costs of mandated vesting, the employer may design its retirement plan to provide for distributions of the cash value of vested accrued benefits to a vested terminated participant shortly after termination of employment. Thus, the existence of more preretirement distribu-

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<sup>177</sup> ERISA included the first statutory vesting requirements. See ERISA of 1974, Pub. L. No. 93-406, §§ 203, 1012(a), 88 Stat. 829, 901 (1974).

<sup>178</sup> See *id.* § 2002(g)(5), (6), 88 Stat. 829, 968 (adding I.R.C. §§ 402(a)(5), 403(a)(4)).

tions to terminated participants creates a need for a system by which those distributions can be transferred and held as retirement savings by the distributees.

In this fashion, pension portability as implemented by mandated vesting leads directly to pension portability in the sense of transfer of the cash values of vested retirement benefits. However, pension portability policy itself does not suggest any limitation on the portability of retirement savings. So long as the participant (or her dependents) are living, there exists the possibility that the retirement savings will be needed at some future time to provide income security for the participant or her dependents. Thus, pension portability policy, if carried to its logical conclusion, would imply that all distributions from a qualified trust ought to be subject to transfer to another retirement savings account, so long as the participant or a dependent is living. In fact, the present rollover rules represent a reasonable approximation of this concept.

#### *B. Pension Portability and Tax-Free Rollover of Retirement Savings*

Under current income tax law, the rollover provisions simultaneously create the rollover transaction and provide that the rollover transfer is not subject to income taxation.<sup>179</sup> Thus, a rollover transfer of retirement savings is, by definition, exempt from income taxation. However, nothing in the nature of a transfer of retirement savings implies that the boundaries of permissible transfers must be exactly congruous with the boundaries of tax-free transfers. It would be possible for retirement plan law to permit the transfer of retirement savings, but for income tax law to provide that the transfer would be an income-taxable event in whole or in part.<sup>180</sup>

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<sup>179</sup> See *supra* text accompanying note 163.

<sup>180</sup> If a transfer of retirement savings were a taxable event, it would be necessary to determine both the amount of retirement savings assets that could be held as retirement savings after the transfer and the income tax treatment of those savings after the transfer. In the typical case, lack of liquidity would compel the participant to use a fraction of her retirement savings to pay the income tax liability arising out of the transfer; thus, the typical case would involve only the after-tax portion of the retirement savings assets being available for transfer to a successor retirement savings account. The transfer rule might incorporate such a limitation, and limit the rollover contribution to only the after-tax portion of the distributed retirement savings assets. However, given that different distributees face widely differing tax rates on retirement trust distributions, the determination of the after-tax fraction of retirement savings that

The general portability policy by itself does not obviously imply any particular income tax treatment of transfers of retirement savings. If, in addition to the general policy favoring portability, it is assumed that pension portability implies that a participant should be able to transfer the *entire amount* of her retirement savings, then pension portability would imply that the transfer must be a tax-free transaction. Tax-free treatment of the transfer would be required because if the transfer were taxable, a portion of the transferred retirement savings would most likely be applied to payment of the income tax liability arising from the transfer.<sup>181</sup> Thus, tax-free treatment of a rollover transfer can be inferred if one assumes that portability policy implies that a participant ought to be able to transfer all of her retirement savings. However, such an assumption simply begs the question of proper income tax treatment; in fact, general portability policy does not provide a guide to the income tax treatment of a transfer of retirement savings.

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could be contributed to the successor retirement savings account would be administratively difficult. Alternatively, the rule might provide that a distributee could roll over the entire amount of her retirement trust distribution, so that if she had sufficient other liquidity to pay the tax, she could preserve the entire amount of the distribution as retirement savings.

By definition, a transfer of retirement savings implies that the retirement savings be transferred to a successor retirement savings account, which implies some continuation of income tax deferral. The issue is whether the earnings on the entire amount of the distribution will be subject to income tax deferral, or only the earnings on an after-tax fraction. This issue is controlled by the rule chosen to govern the amount transferred to the successor retirement trust. If the entire amount of the distribution may be transferred, then earnings on that amount may enjoy income tax deferral. If only an after-tax fraction may be transferred, then only the earnings on this portion would be subject to deferred taxation.

<sup>181</sup> If the transfer were taxable, the participant would owe an income tax liability equal to some fraction of the total value of the transfer. Assuming that the typical participant would have to apply a portion of her former retirement savings to pay this income tax liability, the effects of treating a transfer of retirement savings as a taxable event would be to permit a participant to continue to hold an after-tax portion of her retirement savings, and to divert a portion of the retirement savings to the Treasury at the time of the transfer of the savings. The assumption that a typical participant would find it necessary to pay her income tax liability from the transferred retirement savings is based on the assumption that a typical participant lacks any other sufficient source of liquidity.



*C. Rollover of Retirement Savings Generally Should Be Tax-Free*

Perhaps the best explanation for exempting a rollover transfer of retirement savings from current income taxation lies in the nature of the distinction between retirement savings and all other savings. Savings are identified as retirement savings when they are held in a tax-qualified retirement plan.<sup>182</sup> By definition, a rollover transfer requires that retirement savings be transferred to an eligible retirement plan, which is a tax-qualified retirement trust or IRA.<sup>183</sup> Therefore, a rollover transfer necessarily preserves the identification of the savings as retirement savings. Since the identification of the retirement savings has been preserved, it follows that the income tax deferral for those savings also ought to be continued.<sup>184</sup>

This focus upon the essential nature of retirement plan taxation suggests a concept for defining boundaries for tax-free rollover treatment. This concept would permit a tax-free rollover of any distribution from a qualified trust so long as the distributed amount would have qualified for continued holding in the distributing retirement trust. Stated differently, the concept would imply that all retirement savings ought to be subject to tax-free rollover, except for retirement savings which no longer qualify for continued holding in a tax-qualified retirement plan. The savings that qualify for continued holding in a retirement plan might be referred to, for convenience, as "tax-qualified retirement savings," and the concept that suggests the tax-free rollover of these savings might be denominated the "tax-qualified retirement savings concept."

The tax-qualified retirement savings concept provides a theoretical baseline against which the present law governing tax-free rollovers might be compared. The Code's eligible rollover distribution definition<sup>185</sup> conforms, in part, to the tax-qualified retirement savings concept. The eligible rollover distribution definition generally includes any distribution from a qualified trust; except for a distribution that is one of a series of periodic payments, a distribution compelled by the minimum required distribution rules, or a distribution described in one of the regulatory

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<sup>182</sup> See *supra* text accompanying notes 21-24.

<sup>183</sup> See *supra* text accompanying note 78.

<sup>184</sup> There is no reason to distinguish retirement savings that have been distributed and transferred in a rollover transaction from retirement savings generally.

<sup>185</sup> See *supra* notes 66-69 and accompanying text.

exceptions.<sup>186</sup> The Code also controls the extent to which retirement trust distributions may be rolled over, through its limitations on the maximum amount that may be rolled over.<sup>187</sup> To the extent that each of the Code's exceptions from, and limitations on, rollover treatment describe retirement savings that would not qualify for continued holding in a tax-qualified retirement plan, the Code provision is consistent with the tax-qualified retirement savings concept.

### 1. *Exclusion of Required Minimum Distributions*

Distributions called for by the required minimum distribution rules may not be rolled over.<sup>188</sup> The required minimum distribution rules of I.R.C. § 401(a)(9) mandate that certain minimum distributions be made from a retirement plan to the participant for whom a benefit is held, and that the minimum distributions begin by April 1 of the calendar year following the later of the calendar year in which the participant attains age seventy and one-half, or the calendar year in which the employee retires.<sup>189</sup> In general terms, I.R.C. § 401(a)(9) requires that a participant's benefits be distributed to the participant, or to the participant and her designated beneficiary, over the life of the plan participant, or over the lives of the participant and a designated beneficiary.<sup>190</sup> Thus, if a

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<sup>186</sup> See *supra* notes 66-69 and accompanying text.

<sup>187</sup> See *supra* notes 87-91 and accompanying text.

<sup>188</sup> I.R.C. § 402(c)(4)(B) forbids the rollover of "any distribution to the extent such distribution is required under section 401(a)(9)." I.R.C. §§ 401(a)(9), 402(c)(4)(B) (1994). The prohibition against rolling over a required minimum distribution applies "to the extent" that a distribution is required under I.R.C. § 401(a)(9). For example, if a participant's entire account balance were distributed in a year after the participant had attained age 70½, a portion of the distribution would be a required distribution; to this extent, the distribution would not be an eligible rollover distribution. However, the part of the distribution in excess of this required minimum distribution amount would qualify as an eligible rollover distribution. See *id.* § 402(c)(4)(B).

<sup>189</sup> See *id.* § 401(a)(9)(C) (as amended in 1996). In the case of an employee who is a five percent or greater owner of the employer, or a distribution from an IRA, the minimum distributions must begin by April 1 of the calendar year following the calendar year in which the participant attains age 70½. See *id.*

<sup>190</sup> See *id.* § 401(a)(9)(A)(ii) (1994); Prop. Treas. Reg. § 1.401(a)(9)-1, -2, 52 Fed. Reg. 28,070 (1987). The minimum required distribution rules implement the fundamental policy supporting income tax deferral for "retirement savings." Income tax deferral is justified in order to enhance the participant's income security during the participant's retirement period. As the participant's retirement

participant or her beneficiary receives a distribution that is in whole or in part required to be distributed by the minimum distribution rules, that required distribution cannot be rolled over. The exclusion of a minimum required distribution amount from the eligible rollover distribution definition is consistent with the tax-qualified savings concept. A minimum required distribution amount no longer qualifies to be held by a tax-qualified retirement plan; hence, under the tax-qualified retirement savings concept, that amount should not be rolled over. The Code's prohibition accomplishes this result.

## 2. *Exclusions Added by Regulations*

The statutory definition of the eligible rollover distribution includes *all* distributions, except distributions that are part of a series of substantially equal periodic payments, or that are required minimum distributions.<sup>191</sup> In drafting the statute so broadly, Congress apparently permitted the rollover of certain types of distributions that the Treasury believed should not be rolled over. The Treasury has addressed the statutory overbreadth with additional regulatory exceptions to the eligible rollover distribution definition.<sup>192</sup> For example, I.R.C. § 401(k) plans are required to distribute a participant's elective deferrals to the extent that the participant's deferrals under all I.R.C. § 401(k) plans exceed the I.R.C. § 402(g)(1) limitation.<sup>193</sup> That is, to the extent that a participant's elective deferrals exceed the amount permitted to be held as tax-qualified retirement savings, that excess must be distributed. Under the tax-qualified retirement savings concept for rollovers, these excess deferrals

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period passes, the purpose of income tax deferral is completed, so the tax deferral should be terminated. Tax deferral for retirement savings is terminated by means of a distribution of the savings from the participant's retirement plan. The required minimum distribution rules simply implement the termination of tax deferral. The exclusion of a required minimum distribution from the eligible rollover distribution definition prevents the participant's tax deferral from being further continued. See STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 710 (Comm. Print 1987) [hereinafter '86 Bluebook].

<sup>191</sup> See I.R.C. § 402(c)(4); *supra* notes 66-69 and accompanying text.

<sup>192</sup> See Treas. Reg. § 1.402(c)-2, Q&A-3, 4 (1995).

<sup>193</sup> See I.R.C. § 401(a)(30); Treas. Reg. § 1.402(g)-1(e) (as amended in 1994). The I.R.C. § 402(g)(1) limitation is the maximum amount of elective deferrals that may be contributed by a participant in a single year to a retirement trust; the amount has been adjusted to \$9500 for 1996.

should not qualify for rollover; this provision of the regulations represents sound policy.<sup>194</sup> The other regulatory exclusions from the eligible rollover distribution definition also conform to the tax-qualified retirement savings concept.<sup>195</sup>

Perhaps recognizing the broad sweep of the statutory definition and the seemingly infinite variations of factual situations in the qualified plan field, the regulations authorize the Commissioner to create additional exceptions to the eligible rollover distribution definition by administrative action.<sup>196</sup> The tax-qualified retirement savings concept can provide a consistent policy underpinning for these future administrative refinements of the eligible rollover distribution definition.

### 3. *Exclusion of Periodic Payments*

I.R.C. § 402(c)(4)(A) forbids the rollover of a distribution that is one of a series of *substantially equal* periodic payments.<sup>197</sup> The determination of whether payments are substantially equal is made at the time the payments begin. This means that the anticipated payout from the qualified trust is projected, and if the projected series of payments meets a definition of substantially equal, each one of the payments is excluded from the eligible rollover distribution definition.<sup>198</sup>

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<sup>194</sup> See Treas. Reg. § 1.402(c)-2, Q&A-4(b).

<sup>195</sup> See *id.*, Q&A-4(a). Additional provisions of the regulations exclude corrective distributions of elective deferrals that exceed the I.R.C. § 415 limitations and elective deferrals that must be refunded to bring the plan into compliance with the I.R.C. § 401(k) ADP test. See *id.*, Q&A-4(c). The regulation also excludes the deemed distribution of plan loan proceeds to a participant when the conditions of I.R.C. § 72(p) are violated, dividends on employer stock held by an employee stock ownership plan, and the deemed distribution of PS 58 costs of current life insurance coverage provided to a participant by a qualified plan. See *id.*, Q&A-4(d)-(f).

<sup>196</sup> See *id.*, Q&A-4(g) (allowing exceptions to be designated by revenue rulings, notices, and other guidance in the Internal Revenue Bulletin).

<sup>197</sup> See I.R.C. § 402(c)(4)(A); see also Treas. Reg. § 1.402(c)-2, Q&A-3(b).

<sup>198</sup> See Treas. Reg. § 1.402(c)-2, Q&A-5(a). The determination of whether a projected series of payments will be substantially equal may be based upon rules that have been previously developed under the required minimum distribution rules, see I.R.C. § 401(a)(9), or under rules interpreting the periodic payments exception from the 10% tax on early distributions, see *id.* § 72(t)(2)(A)(iv). See Treas. Reg. § 1.402(c)-2, Q&A-5(a). The regulations under I.R.C. § 402(c) also provide for two additional methods for determination of substantial equality. See *id.*, Q&A-5(d).

There is no logical connection between the tax-qualified retirement savings concept for distributions eligible for rollover and the periodic payments exclusion. A distributee who receives periodic payments might in fact be an individual for whom continued holding of the distributed assets as retirement savings might be entirely appropriate. Payment of a series of periodic payments to a participant might begin at any time after the participant terminated her employment with the sponsoring employer; if the payments began many years prior to the participant's normal retirement age, the participant might desire to continue to hold the entire amount of each payment until she reaches her retirement period. Even a distributee who has begun to receive periodic payments after actual retirement might choose to save a portion of the payments during her early retirement years in order to protect herself against the risk of inflation during her retirement period.<sup>199</sup> In both cases, there is no

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The life expectancy method projects that a distributee will receive equal annual (or more frequent) distribution amounts from the account balance in her defined contribution plan if she lives for a period equal to her life expectancy. Treas. Reg. § 1.402(c)-2, Q&A-5(a) permits the use of methods authorized under I.R.C. § 72(t)(2)(A)(iv) for determination of a series of substantially equal payments. *See* Treas. Reg. § 1.402(c)-2, Q&A-5(a); I.R.C. § 72(t)(2)(A)(iv). I.R.S. Notice 89-25 provides rules for determining when payments are substantially equal under I.R.C. § 72(t)(2)(A)(iv). *See* I.R.S. Notice 89-25, Q&A 12, 1989-1 C.B. 662. I.R.S. Notice 89-25 permits, in the case of defined contribution plan payouts, the use of a life expectancy method. The participant's account balance must be paid in amounts that are anticipated, as of the date of the first payment, to yield level payments for a period equal to the participant's life expectancy. Life expectancy may be determined according to life expectancies in Tables V or VI of Treas. Reg. § 1.72-9, or using other reasonable mortality tables and reasonable interest rates. *See id.* at C.B. 662, 666; Treas. Reg. § 1.72-9 (as amended in 1986); *see generally* BENNETT ET AL., *supra* note 97, ¶ 12.3[4]; Richard B. Toolson, *Structuring Substantially Equal Payments to Avoid the Premature Withdrawal Penalty*, 73 J. TAX'N 276 (1990).

An example given by the regulation states:

[A] series of payments will be considered substantially equal payments over 10 years if the series is determined as follows. In year 1, the annual payment is the account balance divided by 10; in year 2, the annual payment is the remaining account balance divided by 9; and so on until year 10 when the entire remaining balance is distributed.

Treas. Reg. § 1.402(c)-2, Q&A-5(d)(1) (1995).

<sup>199</sup> The fundamental flaw in the periodic payment exclusion is that it operates without reference to the age of the distributee. In contrast, the required minimum distribution rules reference the age of the participant, or the age of the participant

compelling reason to forbid the rollover of all or part of each distribution, so long as any portion of the distribution compelled by the minimum distribution rules is not rolled over.<sup>200</sup>

The periodic payments exclusion from the eligible rollover distribution definition was enacted based upon concerns for the revenue:

[I]f the annuity [i.e., periodic payments] restriction were eliminated, the rollover rules would permit taxpayers to roll over all or part of each retirement annuity payment and could result in a significant revenue loss to the Federal government because liberal rollover rules allow an individual to decide when and how a retirement benefit will be taxed.<sup>201</sup>

Since revenue was the reason for the rule, it is not surprising that the rule is unrelated to the tax-qualified retirement savings concept of identification of savings that qualify to be held as retirement savings. Lacking this connection to an underlying concept, the periodic payments exception

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and her designated beneficiary.

<sup>200</sup> See *supra* note 190 and accompanying text.

<sup>201</sup> STAFF OF JOINT COMM. ON TAXATION, 102D CONG., 1ST SESS., COMPARATIVE DESCRIPTION OF PROPOSALS RELATING TO PENSION ACCESS AND SIMPLIFICATION 10 (Comm. Print 1991). Beyond revenue lost because taxpayers would have greater control over the timing of taxation of distributed retirement savings, the Treasury might have a concern about revenue lost because of noncompliance with reporting requirements. If a distributee were permitted to roll over all or any part of each of a series of distributions, especially distributions paid over an extended period of time, it might be difficult for the IRS to monitor and enforce reporting of the portions of the payments not rolled over, since there would be a large number of transactions over an extended period of time.

The periodic payments rule may have some intuitive validity. It might be suggested that a distributee's retirement income paid out of a qualified trust ought not be rolled over because the purpose of the qualified trust was to accumulate retirement savings until the retirement period. If the distributee has begun to receive her retirement income, prototypically a stream of annuity payments, then the distributee's retirement savings accumulation period has ended, and the distribution period, actual retirement, has begun. Thus, the substantially equal periodic payments test might be seen as a surrogate for identifying the distributee's actual retirement period. However, there is no need to use a surrogate for this simple determination. If this were the purpose of the rule, it would be simpler to forbid any rollover after the distributee attained a specified age, which could reasonably be age 55, 65, or 70½, or some other age.

from the eligible rollover distribution definition cannot fit within a coherent structure of rollover rules.

In any case, as a revenue-protecting limitation on tax-free rollovers, the periodic payments exclusion is ineffective. It should be easy to avoid the periodic payments rule with careful planning, so long as the participant's retirement plan administrator is cooperative and the plan distribution provisions are flexible. For example, the participant could have periodic payments distributed every second year, rather than annually, and thereby bring each distribution within the eligible rollover distribution definition. If the distributee is able to structure a series of payments that are not substantially equal, that is, which vary from year to year in a sufficient amount, each one of these distributions will be an eligible rollover distribution. If a distributee received a single distribution of her entire accrued benefit, that distribution would be an eligible rollover distribution, which could be transferred to an IRA.<sup>202</sup> Once the retirement savings are held in an IRA, the owner of the IRA, the distributee in this example, has practical control over the timing of distributions from the IRA.<sup>203</sup> Thus, she could structure future distributions from the IRA in such a manner that each distribution would itself qualify as an eligible rollover distribution.<sup>204</sup> The periodic payments exception from the eligible rollover distribution definition places a premium on planning and sophisticated advice, and does nothing to advance retirement income security policy. Since the exception of substantially equal periodic payments from the eligible rollover distribution definition is ineffective, and since it is unsupported by any fundamental policy limiting the amount or time of accumulation of retirement savings, this rule ought to be repealed.<sup>205</sup>

#### 4. *Maximum Rollover Amount*

The Code provides that the maximum amount that may be transferred in a tax-free rollover may not exceed the portion of a distribution

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<sup>202</sup> See I.R.C. § 402(c).

<sup>203</sup> See *supra* note 80 and accompanying text.

<sup>204</sup> In fact, the IRA rollover rules might insure that distributions are received less frequently than annually. An IRA rollover is not available to the extent that an IRA distribution has been rolled over within the preceding year. See I.R.C. § 408(d)(3)(B).

<sup>205</sup> If the periodic payments exclusion were repealed, the required minimum distribution rules would define the amount that could not be rolled over, and the balance of each payment could be rolled over.

includable in gross income, determined without reference to the rollover transfer.<sup>206</sup> In effect, this limitation implies that an employee's after-tax contributions to a tax-qualified retirement plan may not be rolled over.<sup>207</sup> Before the distribution of an employee's after-tax contributions, these contributions were qualified for continued holding in the distributing retirement trust. The prohibition on rolling over after-tax contributions is inconsistent with the tax-qualified retirement savings concept, and therefore ought to be repealed.

If the periodic payments exclusion and the prohibition on rollover of employee after-tax contributions were repealed, the eligible rollover distribution definition would include all distributions from a qualified trust, except those necessary to meet the minimum required distribution rules and those excluded by the regulations. Adjustment of the rollover provisions in this manner would conform the Code's rollover rules to the tax-qualified retirement savings concept. This would provide a theoretical underpinning for the rollover system, and allow a coherent structure of rules to emerge.

## VI. THERE SHOULD BE A SINGLE FORM OF ROLLOVER

The preceding analysis suggests that transfer of retirement savings follows from the general pension portability policy, and that the transfer of retirement savings ought to be tax-free if the assets subject to transfer qualify for continued holding in a tax-qualified retirement savings account. Present income tax law provides two alternative forms for rollover transfers, the actual rollover and the direct rollover. In substance, both of these forms accomplish the identical result: a participant's retirement savings are transferred from one retirement trust to a second retirement trust or to an IRA. All eligible rollover distributions may be transferred by either the actual or direct rollover form, and the eligible retirement plans able to receive rollover transfers also are identical for both forms.<sup>208</sup> Properly executed, the two forms of rollover transfer

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<sup>206</sup> See I.R.C. § 402(c)(2); see *supra* notes 87-91 and accompanying text.

<sup>207</sup> See *supra* note 91.

<sup>208</sup> Apparently, part of the same distributable amount could be transferred in a direct rollover, and the balance could be transferred in an actual rollover. See *supra* note 120 and accompanying text. Trustees of eligible retirement plans should be equally willing to accept both forms of rollovers. There is no reason that the trustee of an IRA would distinguish between accepting a direct rollover as contrasted with an actual rollover. Since IRAs are generally sponsored by financial institutions that seek deposits, it is improbable that any institution



have identical tax consequences.<sup>209</sup> In terms of the substantive effects and income taxation of the two forms of rollovers, there is no advantage to one form of transfer as compared with the other.<sup>210</sup>

*A. The Benefits of a Dual Rollover Structure Are Limited*

If it is assumed that a potential distributee who desires to roll over her retirement savings will elect a direct rollover,<sup>211</sup> then the incremen-

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would prefer one form of rollover to another.

If the potential distributee desires to transfer her retirement savings to a qualified trust, presumably one sponsored by her subsequent employer, acceptance of the rollover is dependent upon the qualified trust permitting the acceptance of rollover transfers. *See supra* note 79 and accompanying text. Apparently, a retirement plan sponsor could design its retirement plan and trust to permit the acceptance of either direct or actual rollovers, while forbidding the acceptance of the other form of rollover. The regulations provide protection to the recipient plan that accepts a direct rollover. *See* Treas. Reg. § 1.401(a)(31)-1, Q&A-13(b) (1995). A proposed regulation would provide similar protection to a qualified trust that accepts an actual rollover. *See* Prop. Treas. Reg. §§ 1.401(a)(31)-1, Q&A-14, 1.402(c)-2, A-11, 61 Fed. Reg. 49,279 (1996); *supra* note 79 and accompanying text. Aside from this anomaly in the regulations, there is no rational basis on which an employer could distinguish between a direct rollover and an actual rollover. To the contrary, such a distinction would introduce unnecessary complication into the employer's retirement plan administration.

<sup>209</sup> *See supra* text accompanying notes 55, 137-39. If the actual rollover form of transfer is utilized, the 20% withholding tax is applied to the actual distribution. *See* I.R.C. § 3405(c). However, if the actual distributee transfers a rollover amount equal to 100% of the distributable amount, the distributee would have no income tax liability for the distributed amount, so the withholding tax would be fully refundable. *See supra* note 72 and accompanying text. A direct rollover is treated for income tax purposes and retirement savings asset transfer purposes as a distribution to the potential distributee followed by a transfer by that potential distributee to the eligible retirement plan. *See supra* note 146 and accompanying text.

<sup>210</sup> The direct rollover offers the administrative advantage of exempting the amount transferred in a direct rollover from the 20% withholding tax. *See supra* note 126 and accompanying text. The direct rollover also offers greater certainty that the rollover transfer will not cause unintended tax consequences to the potential distributee. *See supra* text accompanying notes 158-62. For discussion of these advantages of the direct rollover, see *supra* notes 126-42 and accompanying text.

<sup>211</sup> The assumption that a potential distributee will elect a direct rollover is

tal benefits from the dual rollover system can be measured as the gains from permitting a participant who does not elect a direct rollover a further opportunity to roll over her eligible rollover distribution in an actual rollover.<sup>212</sup> The incremental benefit added by the actual rollover alternative is that a distributee who did not elect a direct rollover is offered, in effect, a "second chance" to roll over her retirement savings. If a distributee fails to elect a direct rollover, and then, within sixty days of receiving her actual distribution, decides to roll over that distribution, the actual rollover alternative may permit the distributee to complete a rollover transfer. This "second chance" is the sole advantage of the dual rollover structure.

The second chance for a rollover is useful to two categories of distributees: those who intentionally forego the direct rollover election, but then later make the decision to roll over retirement savings, and those who unintentionally fail to make a direct rollover.<sup>213</sup> In both cases, in

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based upon the reasons discussed in the text, *supra*, accompanying notes 127-30.

There are two possible reasons a distributee might prefer an actual rollover transaction. An actual rollover permits the distributee to retain direct and actual ownership of her retirement savings for a period of 59 days; a distributee could invest the retirement trust distribution and earn personal income for this period. However, this is economically equivalent to receiving a partial distribution that is not rolled over and rolling over the balance of a potential eligible rollover distribution. Another explanation for the receipt of an actual distribution is a distributee's desire to have an additional 59 days in which to decide whether or not to roll over her retirement savings. However, an actual distribution may not be made to a distributee before she has received the cash-out explanation and consented to receive the distribution. *See supra* note 44 and accompanying text.

<sup>212</sup> It might be suggested that the dual system provides "flexibility," or accommodates different preferences, and that two forms of transfer are therefore necessarily preferable to a system that provides only one form of transfer. A mere increase in the number of methods by which a participant might accomplish a transfer of her retirement savings is not an advantage. A dual system adds complexity to retirement plan distribution law and administration, and that complexity must be justified by benefits to participants or retirement plan sponsors.

<sup>213</sup> This assumes that the plan sponsor has designed the plan so that the default alternative when a distributee fails to elect a direct rollover is for the trustee to pay the distribution to the distributee in an actual distribution. *See supra* note 60. Before receiving an actual distribution, a potential distributee must have been provided with the information that precedes the I.R.C. § 411(a)(11) consent, and she must have been provided with the rollover explanation, which includes her direct rollover election right.

order for the second-chance rollover opportunity to have any benefit, the actual distributee must perfect her actual rollover within sixty days of receipt of the distribution. Thus, the period in which a second chance is useful is very short. There is no reason to expect that any significant number of potential distributees who choose to receive a distribution would subsequently discover a reason to reverse their prior decision within this short period. Nor is there any reason to expect that any significant number of distributees who receive an actual distribution because of an unintentional failure to elect a direct rollover would then perfect an actual rollover within the sixty-day period. Thus, the total benefits of the dual rollover system are limited.

*B. The Dual Rollover System Creates Complexity and Increases Administrative Costs*

The limited benefits of the dual rollover system must be balanced against its disadvantages. A serious disadvantage of the dual rollover structure is the additional complexity it introduces into retirement plan distribution taxation law and administration. The alternative structure creates complexity because there are important differences between the actual rollover and direct rollover transactions. An actual rollover requires that the participant receive an actual distribution, while a direct rollover implies that the distributee must not receive an actual distribution of her retirement savings. In an actual rollover transaction, the distributee is personally responsible for arranging for the transfer of all or any portion of the distribution to an eligible retirement plan, completing the transfer within the sixty-day rollover period, and electing that the transfer be treated as a rollover contribution.<sup>214</sup> For a direct rollover, the potential distributee must provide the plan administrator with sufficient information to enable the plan administrator to transfer the distributee's retirement savings to a designated successor eligible retirement plan.<sup>215</sup> Each of these alternatives must be communicated to a distributee; this makes the explanation more lengthy than it otherwise would be, necessitates

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<sup>214</sup> See *supra* Parts II.A.8, II.A.11-12.

<sup>215</sup> The I.R.S. Notice 92-48 "Safe Harbor Explanation" does not specifically address the obligation of the potential distributee to provide the plan administrator with information sufficient to permit the plan administrator to transfer the potential distributee's retirement savings directly to an eligible retirement plan, nor any default rules the plan administrator will apply if the distributee fails to affirmatively elect either a direct rollover or an actual distribution. See I.R.S. Notice 92-48, § III, 1992-2 C.B. 377, at 379.

additional documentation, and makes the explanation and the transactions less comprehensible to a potential distributee. Even the fundamental distinction between a direct rollover and an actual rollover will not easily be communicated to many retirement plan participants.

The difficulty of comprehension associated with the present dual structure for rollover transfers should be of particular concern because of the numbers and types of taxpayers affected by these rules. Between 1987 and 1990, there were 46 million lump-sum total distributions from retirement programs, with almost 11 million distributions in 1990 alone.<sup>216</sup> These figures relate to lump-sum total distributions; the eligible rollover distribution definition is much broader and it can be assumed that an even larger number of taxpayers are affected by the dual rollover structure. In 1992, the Senate Finance Committee estimated that as many as 16 million individual taxpayers might be affected by the pension distribution taxation rules.<sup>217</sup> A wide variety of taxpayers are affected by the dual rollover structure. While some of the affected taxpayers may be sufficiently well-versed to comprehend the rollover alternatives, many other distributees, not sophisticated in taxation or financial matters, must find the rollover structure to be impenetrable.<sup>218</sup> The complexity of the dual rollover structure affects a large and diverse portion of the taxpaying public.

The disclaimer at the end of the four-page model rollover explanation published by the IRS summarizes the difficulties posed by the retirement plan distribution rules:

The rules described above are complex and contain many conditions and exceptions that are not included in this notice. Therefore, you may want to consult with a professional tax advisor *before* you take a payment of

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<sup>216</sup> See Yakoboski, *supra* note 3.

<sup>217</sup> See SENATE FINANCE COMM., 102D CONG., 2D SESS., TECHNICAL EXPLANATION OF THE SENATE FINANCE COMMITTEE AMENDMENT TO H.R. 4210, WITH MINORITY VIEWS, FAMILY TAX FAIRNESS, ECONOMIC GROWTH, AND HEALTH CARE ACCESS ACT OF 1992, 108-09 (Comm. Print 77 1992). "The number of special rules for taxing pension distributions makes it difficult for taxpayers to determine which method is best for them and also increases the likelihood of error. In addition the specifics of each of the rules create complexity." *Id.* at 109.

<sup>218</sup> Just as taxpayers find the several special rules for taxing plan distributions to be a source of difficulty, see *supra* note 217, some taxpayers will have difficulty distinguishing between two forms of rollover that accomplish the same result, in substance.

your benefits from the Plan. Also you can find more specific information on the tax treatment of payments from qualified retirement plans in IRS Publication 575, *Pension and Annuity Income*, and IRS Publication 590, *Individual Retirement Arrangements*.<sup>219</sup>

To the extent that retirement trust distributees heed the advice to obtain professional advice, they will bear the additional costs of the fees for that advice. The complexity of the rules that must be complied with to achieve a successful rollover imposes economic costs upon taxpayers generally. The dual structure of the rollover provisions makes a significant contribution to this complexity.

The complexity associated with the dual rollover structure also imposes additional costs upon retirement plan sponsors. Before 1993, a retirement plan was not required to provide participants with an option to transfer a potential distribution directly to an IRA or another retirement trust, so a retirement plan could provide that any distributable benefits would be paid to the participant entitled to those benefits.<sup>220</sup> The Unemployment Compensation Amendments of 1992 ("UCA") added the requirement that a retirement plan must provide a participant with the election to transfer the participant's distributable benefit directly to another qualified trust or to an IRA.<sup>221</sup> This change in the law imposed on retirement plan sponsors the one-time cost of conforming their plans to the new qualification requirement and adjusting their administrative practices to conform to the new requirements.<sup>222</sup> In addition to this one-

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<sup>219</sup> I.R.S. Notice 92-48, § IV, 1992-2 C.B. 377, at 381. IRS Publication 575 runs to 40 pages; 590, to 71 pages.

<sup>220</sup> See *supra* text accompanying notes 9, 62-64.

<sup>221</sup> See *supra* notes 9-10 and accompanying text.

<sup>222</sup> In analyzing pension simplification proposals that preceded the UCA, the Staff of the Joint Committee observed that it was an important issue "whether additional legislation with respect to a rule that has already been subject to significant legislation itself creates complexity." STAFF OF THE JOINT COMM. ON TAXATION, 101ST CONG., 2D SESS., SIMPLIFICATION OF PRESENT-LAW TAX RULES RELATING TO QUALIFIED PENSION PLANS 3 (Comm. Print 1990). The imposition of the requirement that a retirement plan must provide an election to a potential distributee to transfer her distributable benefit was widely criticized at the time it was enacted. See, e.g., Leandra Lederman Gassenheimer, *The New Rollover Rules and Twenty Percent Withholding Tax On Pension Distributions: Does Good Pension Policy Favor Their Repeal?*, 7 ST. THOMAS L. REV. 75 (1994); Mala Narayanan, Note, *The Feds Want Your Retirement Savings: The Direct Rollover and Unfair Mandatory Income Tax Provisions of the Unemploy-*

time cost, it is necessarily more expensive to administer a retirement plan with two alternative methods by which a participant's distributable benefits may be paid out than to administer a retirement plan that could always fulfill its obligations by distributing a participant's benefit to that participant.<sup>223</sup> A retirement plan distributee's difficulties with the dual rollover structure may also impose additional complexity and costs upon the plan sponsor. To the extent that potential distributees require explanation beyond that provided by a rollover explanation form, there will be pressure on the retirement plan sponsor to provide that explanation. Providing this information to employees will increase the employer's personnel and retirement plan administration costs. Alternatively, to the extent that the employer fails to provide the information, there will be an adverse effect upon employee morale. Thus, the dual rollover structure will be more expensive to administer than the prior regime.

Increases in the administrative costs of an employer's retirement plan are important because of the effect these costs have upon the compensation of retirement plan participants. The administrative costs of a retirement plan are another form of labor cost that the employer nominally pays; however, over time, the incidence of these labor cost increases will shift to the employees in the form of reduced amounts of compensation that can be paid to the employer's workers.<sup>224</sup> Since retirement plan administrative costs are directly associated with the employer's payment of deferred compensation in the form of tax-qualified retirement savings, it is likely that an increase in those administrative costs will result in reduced amounts of retirement savings for retirement plan participants generally.

The benefit of the dual rollover structure is that it permits an actual distributee a "second chance" to roll over her retirement trust distribution within the sixty-day period. It is unlikely that this alternative is of real benefit to any significant number of taxpayers. The costs of this system are borne personally by the millions of retirement plan participants in

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*ment Compensation Amendments Act of 1992*, 27 RUTGERS L.J. 205 (1995).

<sup>223</sup> If the potential distributee elects a direct rollover, the plan administrator must collect the information necessary to execute the direct rollover. *See supra* text accompanying notes 131-33; *see, e.g.*, David A. Hildebrandt & Jeffrey R. Capwell, *New Law Liberalizes Rollovers, Complicates Tax Withholding on Qualified Plan Distributions*, TAX MANAGEMENT COMPENSATION PLANNING, Jan. 1, 1993, at J.3, available in LEXIS, BNA Library, TMCPJ File (providing a three-page chart to guide a retirement plan administrator through the plan distribution tax withholding and direct rollover rules).

<sup>224</sup> *See supra* note 20.

approximately 700,000 retirement plans who must personally unravel the complexity of the dual rollover system or pay professionals to advise them, and who will receive reduced retirement benefits as a result of the increased administrative costs of the dual rollover system. The dual rollover structure should be simplified by elimination of one of the forms of rollover. The analysis below concludes that the direct rollover alternative should be eliminated, and the actual rollover should be the sole form for transfer of retirement savings.

*C. A Direct Rollover Is Exempt from the Twenty Percent Withholding Tax*

Since the existing Code provisions exempt a direct rollover from the twenty percent withholding tax that applies to an eligible rollover distribution, a potential distributee of a potential eligible rollover distribution who intends to roll over her distribution should elect to have the distributable amount transferred in a direct rollover.<sup>225</sup> Thus, from the perspective of a potential distributee who is deciding how to transfer her retirement savings, the direct rollover form is the clear choice. However, in this analysis of the structure of the rollover law, the existing withholding tax preference for the direct rollover is not dispositive. The question is not which form of rollover transfer *is* preferred by current law; instead, the question is which form of rollover *ought* to be preferred.<sup>226</sup> The answer to this question should be based upon the fundamental benefits and costs associated with each form of rollover. If the actual rollover form offers a better balance of benefits and costs, then the withholding tax treatment of an actual rollover can be adjusted so that it is equivalent to that presently applied to a direct rollover.

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<sup>225</sup> See I.R.C. § 3405(c)(2) (1994); *supra* notes 127-29 and accompanying text.

<sup>226</sup> The exemption of a direct rollover transfer from the 20% withholding tax represents an explicit choice by Congress to favor the direct rollover as compared with the actual rollover. Correlatively, the absence from the Code of provisions that would exempt an actual distribution from the 20% withholding tax if the distributee files a certificate that she intends to roll over the distribution also represents an explicit choice by Congress to favor the direct rollover form of transfer. The question addressed in the text is whether the preference for the direct rollover form of transfer can be justified on the basis of sound policy.

## VII. COMPARING ACTUAL AND DIRECT ROLLOVERS

### A. *Administrative Responsibilities*

Superficially, it might appear that the direct rollover system simplifies the administration of a rollover transfer, at least from the perspective of a retirement plan participant. A direct rollover might appear more simple if its concept is compared with the concept of an actual rollover. In concept, under the direct rollover system, when a participant's retirement savings become distributable to her, if she desires to transfer those savings to another retirement account, she need do nothing more than direct the plan administrator of her retirement plan to transfer the present value of her retirement benefit to a designated eligible retirement plan. In contrast, the concept of an actual rollover transfer involves two steps, the participant's receipt of an actual distribution and the transfer of those funds to another retirement account.<sup>227</sup> However, the devil is in the details of implementation, and as implemented by the regulations, the direct rollover system in fact increases the administrative burdens associated with rollover transfers for both retirement plan participants and administrators.

#### 1. *Participants*

Certain administrative responsibilities of a retirement plan participant are identical under both forms of rollover transfer. With both forms of rollover, the participant must identify an eligible retirement plan, and if the eligible retirement plan is to be an IRA, the participant must create that IRA. Furthermore, as with an actual rollover, the plan administrator of the distributing plan in a direct rollover might deliver a check to the participant, so that she will have personal responsibility for the actual physical transfer of the distribution.<sup>228</sup> Thus, it is possible that the name of the payee on the distribution check would be the only change that a participant might observe between the actual transfer aspects of an actual rollover and a direct rollover.

The additional complexity introduced by the direct rollover system stems from its requirements that the plan administrator of the transferring plan determine the identity of and full descriptive information about, the

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<sup>227</sup> See *supra* notes 76-77 and accompanying text.

<sup>228</sup> See Treas. Reg. § 1.401(a)(31)-1, Q&A-4 (1995); *supra* note 135 and accompanying text.



eligible retirement plan and confirm that the eligible retirement plan will accept the rollover transfer, and from its imposition of the twenty percent withholding tax with the withholding tax exemption for direct rollovers.<sup>229</sup> In the case of an actual rollover, the participant must obtain this same information in order to perfect her rollover transfer, but she is not obligated to provide documentary evidence of the information to her plan administrator or to any other party. In effect, the direct rollover regulations require the plan administrator to impose upon a potential distributee the responsibility to prospectively establish the validity of her proposed rollover transaction before the transaction is initiated. A potential distributee may find this more burdensome than simply completing an actual rollover transfer herself; in any case she will not find that the direct rollover system offers her simplicity of administration.<sup>230</sup>

## 2. Plan Administrators

Before making a retirement plan distribution, a plan administrator must provide the participant with the cash-out explanation and, if required, obtain a consent to the distribution from the participant, and, if applicable, provide the potential distributee with the rollover explanation. Under the actual rollover system, after completion of these steps, the plan administrator may proceed to make a distribution, and payment of the distribution will terminate the relationship between the retirement trust and the distributee.<sup>231</sup> Responsibility for the validity of the rollover rests with the distributee.<sup>232</sup>

In contrast, the direct rollover system requires the plan administrator to have substantial administrative involvement in a participant's rollover transaction. Under the direct rollover system, the plan administrator must of course provide the same cash-out explanation and rollover explanation, but beyond this, as a practical matter, the plan administrator must verify all aspects of the participant's proposed rollover, including the exact amount of the eligible rollover distribution<sup>233</sup> and the validity of the

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<sup>229</sup> See I.R.C. § 3405(c); Treas. Reg. § 31.3405(c)-1, Q&A-6, -7.

<sup>230</sup> The benefit of this intense administration is increased certainty of compliance with the rollover requirements. See *infra* Part VII.B.

<sup>231</sup> See *supra* note 64 and accompanying text.

<sup>232</sup> See *supra* Part II.A.8.

<sup>233</sup> The plan administrator must determine whether, and to what extent, a distribution is an eligible rollover distribution, or if it is excluded as a periodic payment or as a required distribution under I.R.C. § 401(a)(9). See I.R.C.

direct rollover transfer.<sup>234</sup> The plan administrator also must document the identity of, as well as all other relevant information about, the participant's designated eligible retirement plan. The plan administrator acts as prospective auditor of the proposed rollover transfer. If the plan administrator identifies possible flaws in the participant's proposed rollover transfer, the plan administrator may not proceed with the direct rollover transfer. While the regulations impose no explicit obligations on a plan administrator in this situation, the administrator's prudent course of action would be to communicate with the participant about the apparent flaws with a view to correction of the proposed rollover.<sup>235</sup> In effect, the direct rollover system imposes on the plan administrator substantial duplicate responsibility for the validity of the participant's rollover.

#### *B. Certainty of Compliance for Participant*

The additional responsibility that the direct rollover system places upon a plan administrator provides the plan participant with heightened certainty that her rollover, in the form of a direct rollover, will comply with the rollover requirements. Since the participant's plan administrator must verify compliance with the rollover requirements before initiating a rollover transfer, there is an increased certainty that all requirements will be satisfied. In order to appreciate this effect, consider the situation

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§ 402(c)(4). The regulations permit the plan administrator to assume that there is no designated beneficiary for purposes of determining the amount of any required minimum distribution. *See* Treas. Reg. § 31.3405(c)-1, Q&A-10(c). If a distribution is made in the form of property, the plan administrator is responsible for determining the value of the property. *See id.* § 35.3405-1, Q&A F-1 (as amended in 1983). The plan administrator must limit any transfer to an amount not in excess of the amount that would be includable in the potential distributee's gross income if the distribution were actually made. *See* I.R.C. § 402(c)(2).

<sup>234</sup> The plan administrator of the transferring plan will not collect the 20% withholding tax from the amount transferred in a direct rollover. If it is later determined that the direct rollover was not valid, then the plan administrator risks effective personal liability for the amount of the withholding tax not properly collected. *See* I.R.C. § 6672(a) (imposing a 100% penalty tax on a responsible person who willfully fails to collect or pay over a withholding tax); *id.* § 7501.

<sup>235</sup> "For example, it is not reasonable for the plan administrator to rely on information that is clearly erroneous on its face." Treas. Reg. § 31.3405(c)-1, Q&A-7(a).

that existed before the enactment of the direct rollover system, when the actual rollover was the only form in which a rollover transfer could be completed.

With an actual rollover transfer, the actual distributee must perfect her rollover within the sixty-day rollover period, on pain of having her entire distribution included in gross income and possibly being subjected to the ten percent tax on early distributions.<sup>236</sup> A participant may not enjoy a high degree of certainty that she has accomplished a valid direct rollover because the rollover requirements are complex, and the actual distributee is solely responsible for compliance with those requirements. Before the enactment of the direct rollover system, there was concern that this combination of complex law and individual responsibility for compliance might lead to cases in which taxpayers suffer unintended taxation of retirement plan distributions. This concern provided some of the impetus for enactment of the direct rollover system. A Ways and Means Committee Report explained the problem:

The complexity of the restrictions on rollovers under present [i.e., 1992 pre-UCA] law (e.g., the 60-day rule) lead to numerous inadvertent failures to satisfy the rollover requirements.

Results similar to those under present law can be obtained without the complexity added by the special tax rules of present law. For example, liberalization of the rollover rules will increase the flexibility of taxpayers in determining the timing of the income inclusion of pension distributions and eliminate the need for 5-year averaging.<sup>237</sup>

In fact, during the years since the 1974 enactment of the actual rollover provisions, there have been cases in which retirement plan distributions were subjected to income taxation because the distributee failed to successfully perfect an actual rollover.<sup>238</sup>

In addition to reducing the risk of noncompliance with the rollover requirements by means of the involvement of the plan administrator, the structure of the direct rollover transfer reduces the risk of inadvertent taxation.<sup>239</sup> The increased certainty that a direct rollover will comply

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<sup>236</sup> See *supra* note 102 and accompanying text.

<sup>237</sup> H.R. REP. NO. 631, 102d Cong., 2d Sess. 96 (1992).

<sup>238</sup> See *supra* note 102 and accompanying text.

<sup>239</sup> See *supra* notes 138-39 and accompanying text. But see *supra* notes 152-54 and accompanying text (analyzing the case of a direct rollover gone wrong by means of an actual distribution being mistakenly made to the participant).

with the rollover requirements and will not result in unintended taxation to the participant requires the plan administrator to undertake increased administrative responsibility. This more intensive administration of the employer's retirement plan will necessarily increase the costs and expenses associated with the operation of the plan. Thus, the issue becomes a balance between the benefit of increased certainty for some retirement plan participants and the costs incurred for that certainty.

Increased certainty of compliance with the rollover requirements benefits those retirement plan participants who choose to roll over their distributions, and the magnitude of the benefit depends upon the degree of risk that a rollover might fail to satisfy all requirements and thereby result in unintended taxation. The Ways and Means Committee Report accompanying the enactment of the direct rollover system asserted that there were "numerous inadvertent failures of compliance with the rollover requirements."<sup>240</sup> No data is offered to support this assertion, nor is evidence available that suggests that inadvertent noncompliance was in fact a widespread problem. The reported decisions addressing failed rollovers are few in number.<sup>241</sup> Studies of pension portability omit difficulty of compliance with the direct rollover rules as a basis for revision of the rollover structure.<sup>242</sup> If noncompliance were a pressing problem, one must wonder why the actual rollover system was left in place for eighteen years before it was supplemented. These questions create some doubt about the magnitude of the noncompliance problem.

Obviously noncompliance with the pre-1992 direct rollover requirements did cause some taxpayers to suffer unintended income tax consequences as a result of rollover transfers gone wrong. However, the important judgments are whether this noncompliance was sufficiently widespread to justify the direct rollover system, and whether this system is the best solution to whatever problem might have existed. In making these judgments, it is important to consider that the direct rollover system is invoked for many, perhaps most, distributions from retirement plans. The eligible rollover distribution definition is broad and encompasses all distributions except certain periodic payments and required minimum distributions.<sup>243</sup> And the direct rollover system applies to every eligible

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<sup>240</sup> H.R. REP. NO. 631, 102d Cong., 2d Sess. 96 (1992).

<sup>241</sup> See *supra* note 102 and accompanying text.

<sup>242</sup> See TURNER ET AL., *supra* note 79; Joseph S. Piacentini, *Preservation of Pension Benefits*, 98 EMPL. BENEFIT RESEARCH INST. ISSUE BRIEF (1990); Andrews, *supra* note 174.

<sup>243</sup> See *supra* note 66 and accompanying text.

rollover distribution, without regard to whether the potential distributee has any interest in rolling over her retirement savings. In other words, the direct rollover system is a universal solution for what was, at worst, a problem of "numerous inadvertent failures"<sup>244</sup> over an eighteen-year period during which apparently millions of taxpayers successfully rolled over retirement plan distributions.<sup>245</sup> The direct rollover system is an overbroad solution to the noncompliance problem.

The direct rollover system also involves a mismatch between the benefits of the system and the incidence of the system's costs. Only participants who roll over a distribution benefit from increased certainty of compliance with the rollover requirements. The increased administrative costs of the system reduce compensation for retirement plan participants generally, probably in the form of reduced retirement benefits.<sup>246</sup> This mismatch of costs and benefits raises serious concerns about the wisdom of the direct rollover system.

### *C. Direct Rollovers and Preservation of Preretirement Distributions*

Perhaps a deeper justification for the direct rollover system might be found if that system made an important contribution to the preservation of preretirement distributions as retirement savings.<sup>247</sup> If the direct rollover system were to cause retirement plan participants to preserve more of their retirement savings for retirement purposes than would be preserved under a system in which the actual rollover were the only form of transfer, then this increase in preservation of retirement savings might justify the increased administrative costs imposed by the direct rollover system.

#### *1. The Direct Rollover Form Does Not Enhance Preservation of Retirement Savings*

In order to assess whether the direct rollover form of transfer enhances the preservation of retirement savings, consider the context in

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<sup>244</sup> See *supra* text accompanying note 140.

<sup>245</sup> If the problem were inadvertent failure to comply with rollover requirements, the solution for that problem would be the enactment of legislation granting the IRS authority to permit retroactive correction of failed attempts at actual rollovers. In the absence of evidence that this is a widespread problem, there is no reason to believe that this would impose a material administrative burden on the IRS.

<sup>246</sup> See *supra* note 20 and accompanying text.

<sup>247</sup> See *supra* text accompanying notes 41-43.

which a participant decides whether to preserve her retirement savings. For most preretirement distributions, after a participant's retirement savings become distributable, the participant must consent to receive the distribution.<sup>248</sup> After the participant has consented, a distribution may be paid to the participant, and it is this distribution being payable that triggers the direct rollover election.<sup>249</sup> As a practical matter, the consent to receive the distribution and the direct rollover election will be considered by the potential distributee at the same time, and will be parts of a single decision the participant reaches as to the disposition of her retirement savings.<sup>250</sup>

If the participant has no reason to consent to receive a distribution of her retirement savings, then those savings will continue to be held by her current retirement plan. If the participant decides on another disposition for her retirement savings, then she must consent to receive a distribution, and take whatever steps are implicated by her decision. In order for the participant to be motivated to take these affirmative steps, she must have a reason to act. The motivation that causes the participant to consent to receive a distribution will be the same motivation that controls the participant's disposition of that distribution. There are two important reasons why a participant would consent to receive a distribution of her retirement savings.<sup>251</sup> First, the participant might desire to obtain her

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<sup>248</sup> See *supra* note 45 and accompanying text.

<sup>249</sup> See I.R.C. §§ 401(a)(31), 411(a)(11) (1994).

<sup>250</sup> The administrative procedures preceding a distribution from a retirement plan will bundle the I.R.C. § 411(a)(11) consent with the I.R.C. § 401(a)(31) direct election. See *id.* §§ 401(a)(31), 411(a)(11). The participant will give her consent to receive a distribution at the same time that she chooses to receive the distribution as an actual distribution or elects to transfer the distributable eligible rollover distribution in a direct rollover. Since in a single decision the participant consents to receive the distribution of her retirement savings and elects to either preserve or consume those savings, there is little likelihood that the participant would consent to receive a distribution, intending to roll over the distribution, but then fail to complete a rollover after the distribution became payable to her. Cf. Weiss, *supra* note 20 (discussing psychology experiments in which subjects' preferences apparently shift over time).

<sup>251</sup> This analysis assumes that a participant who elects a preretirement distribution does so because she intends to consume the distribution or to roll over the distribution. Another assumption would be that the participant elects a preretirement distribution but has no fixed purpose for receiving the distribution, that is, that she does not know whether she will consume the distribution or roll over the distribution. Generally, it seems unlikely that a participant would elect to receive a distribution without having some reason to do so. If the participant

accumulated retirement savings in order to apply those funds to immediate consumption, or she might desire to transfer the retirement savings in a rollover transfer so as to hold the savings in a different employer-sponsored retirement plan or in an IRA.<sup>252</sup>

Consider first the case of a participant who elects to receive a preretirement distribution because she plans to consume the distribution. This is the case the policy of preservation of retirement savings should address. Under existing law, the potential distributee receives the rollover explanation, and that explanation explains to the potential distributee that she has a legal right to elect to have her distributable retirement savings transferred in a direct rollover, and that even if she does not elect a direct rollover, she may still transfer any portion of her eligible rollover distribution in an actual rollover.<sup>253</sup> However, since the assumption is that the participant's motivation for consenting to receive the eligible rollover distribution is her desire to apply the distribution to consumption, there is no reason to believe that the information about the rollover opportunities will influence the participant's choice to consume or to roll over her retirement savings.<sup>254</sup> In short, for the potential distributee who

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desired to receive a distribution from her former employer's retirement plan in order to obtain unrestricted access to her retirement savings, then a rollover to an IRA would give her essentially unrestricted access, and she could hold the savings in the IRA until she decided to consume the assets. *See supra* note 171 and accompanying text. In effect, this case reduces to a case in which the participant intends to roll over her savings.

<sup>252</sup> *See supra* note 57 and accompanying text.

<sup>253</sup> The participant may glean from the information that she can avoid the withholding tax by electing a direct rollover to an IRA and then withdrawing the rolled-over amount from the IRA.

<sup>254</sup> This case illustrates the inherent shortcoming of any voluntary rollover provision as a means to preserve retirement savings. If a participant has decided to consume a preretirement distribution, the availability of one, two, or twenty forms of voluntary rollover transfer will not change her intention to consume. The solution to the problem of consumption of preretirement distributions is for the law to forbid preretirement distributions. However, an employer-sponsored plan legitimately needs a means to eliminate the administrative burdens associated with a small vested benefit held for a terminated participant who will attain retirement age many years in the future. This need could be met through a system of a mandatory direct rollover to an IRA established for the benefit of the terminated participant. In order for such an IRA to effectuate the purpose of preservation of the retirement savings, it would be necessary to amend the IRA provisions to provide that such a mandatory rollover IRA could not be distributed until the owner attained some specified age, or until certain other events

has decided to consume her distribution, the availability of a direct rollover alternative is irrelevant; this distributee will receive an actual distribution and apply it to consumption spending. For this type of potential distributee, the direct rollover system will not enhance the preservation of retirement savings.

Second, consider the case in which a potential distributee consents to a distribution of her retirement savings in order to roll the savings over into another retirement plan or into an IRA. The inquiry is whether the direct rollover form of transfer would cause a participant to be more likely to roll over her retirement savings than would be the case if the actual rollover form were the only means for a rollover transfer. The essential difference between the direct rollover and the actual rollover forms of transfer of retirement savings is that the direct rollover form eliminates the potential distributee's receipt of an actual distribution. If the direct rollover system is to enhance the preservation of preretirement distributions, there must be some connection between the elimination of the actual distribution and a potential distributee's decision to roll over her retirement savings.

Under the direct rollover system, before a plan administrator may disburse an actual distribution, the potential distributee will have an immediate choice whether to receive that actual distribution or elect a direct rollover.<sup>255</sup> In contrast, under the actual rollover system, a distributee consents to the receipt of an actual distribution, receives the distribution, and then retains the distributed amount or transfers it in an actual rollover. Thus, the essential difference between the direct rollover system and the actual rollover system reduces to the forms of the choices a participant has after consenting to receive an immediate distribution of the value of her accrued benefit. Under the direct rollover form, the participant chooses to forgo an immediate distribution of the value of her retirement savings, and with an actual rollover, the participant chooses to transfer a distribution actually received. Rationally, these two choices are essentially equivalent. Assuming that retirement plan participants generally make rational choices, a mere difference in the form of the choice presented should not materially affect participants' choices to consume a preretirement distribution or to roll over that distribution. Thus, the direct rollover form of transfer, simply as a matter of form, should not enhance the preservation of preretirement distributions as retirement savings as compared with the actual rollover form.

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occurred, such as disability.

<sup>255</sup> See *supra* notes 49-51 and accompanying text.



If one allows for the possibility that retirement plan participants might make irrational choices about retirement savings, the question becomes whether there is any likely connection between the form of the choices presented by the direct rollover and actual rollover systems and potential distributees' decisions to transfer retirement savings in a rollover transfer. The obvious factor that might influence distributees' choices is that the actual rollover form requires an actual distribution, and it might be suggested that if a retirement plan participant has actual funds in hand, she will be influenced by that fact of actual possession to consume the funds, rather than to transfer them in an actual rollover.<sup>256</sup> It is unlikely that the mere fact of actual possession will generally influence retirement plan distributees to consume a distribution which could have been preserved if the participant had elected a direct rollover. A potential distributee will typically be presented with the right to receive an actual distribution simultaneously with the receipt of her rollover explanation.<sup>257</sup> If a participant who receives an actual distribution would consume that distribution, it seems unlikely that the same participant, in the guise of a potential distributee, would waive the receipt of that actual distribution. Assuming that a potential distribution is generally as likely to be consumed as an actual distribution, then the direct rollover alternative will not systematically enhance the preservation of preretirement distributions.

To summarize, when an event occurs that permits a preretirement distribution of a participant's retirement savings under an employer-sponsored retirement plan, the participant will be presented with the choice of leaving her retirement savings invested in her existing retirement plan, or receiving an actual distribution of that benefit, or transferring the distributable or distributed eligible rollover distribution in a rollover transfer. The potential distributee will have the choice either to receive an immediate distribution, or to waive that distribution and to elect a direct rollover. There is little reason to posit that potential distributees will systematically elect direct rollovers in cases in which they would have consumed an actual distribution. These essentially cosmetic adjustments in the form of the choices presented to retirement plan participants will not have any systematic influence on the preservation of preretirement distributions as retirement savings.

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<sup>256</sup> Cf. Weiss, *supra* note 20, at 1312-18 (arguing that forms of choice presented to employees may influence retirement savings behavior).

<sup>257</sup> The potential distributee will receive the cash-out explanation and the rollover explanation at the same time, and will make her choices essentially at the same time. See *supra* text accompanying notes 44-52.

2. *Involvement of the Plan Administrator  
Does Not Enhance Preservation of Retirement Savings*

A significant element of the direct rollover system is the increased involvement of the plan administrator in the rollover transfer of a plan participant.<sup>258</sup> It might be suggested that this increased involvement would contribute to enhanced preservation of retirement savings, and that this effect could provide a justification for the increased costs of the direct rollover system. However, analysis of the relationship between the retirement plan administrator's involvement in the rollover transfer and the participant's rollover decision suggest that this element of the direct rollover system will have no systematic effect upon preservation of retirement savings.

The retirement plan participant has the exclusive legal right to control the disposition of a distribution of her retirement savings.<sup>259</sup> The plan administrator has no legal right nor standing to control the distribution. The only influence a plan administrator might have over the participant's decision-making would depend on the plan administrator educating the potential distributee about the benefits of a direct rollover.<sup>260</sup> A plan administrator should avoid going beyond neutral educational efforts; an attempt to persuade a plan participant to decline to receive an immediate distribution to which the participant has a legal right could subject the plan administrator to liabilities under ERISA for interference with the participant's rights to receive the benefits specified in the plan document.<sup>261</sup> Since the plan administrator's efforts relating to preservation of the preretirement distribution must be strictly limited to neutral educational information, there is no reason to believe that providing this information in the context of a direct rollover would somehow result in an incidence of rollovers greater than would be the case if the information were provided in the context of the participant's decision to transfer the distribution in an actual rollover.

To the contrary, to the extent that the direct rollover system requires that plan administrators devote resources to the increased administrative

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<sup>258</sup> See *supra* Part VII.A.2.

<sup>259</sup> The participant may share that control with the participant's spouse under the various provisions giving spouses rights in a participant's accrued benefit under her retirement plan. See I.R.C. §§ 401(a)(11), 417 (1994); ERISA § 205, 29 U.S.C. § 1055 (1994).

<sup>260</sup> The rollover explanation provides a very basic introduction for a participant about the rollover alternatives and preservation of retirement savings.

<sup>261</sup> See ERISA §§ 401(a), 502, 29 U.S.C. §§ 1132, 1140.

responsibilities of the direct rollover transaction, and to compliance with the twenty percent withholding tax, fewer resources may be available for educating potential distributees about the importance of preserving a preretirement distribution for retirement purposes. If such a diversion of resources occurs, the direct rollover system might reduce the incidence of rollover by casting plan administrators in the role of auditor and tax administrator rather than retirement benefits counselor.

### 3. *Rolled-Over Retirement Savings Are Accessible to Participants*

The fundamental reason the direct rollover system will not contribute to enhanced preservation of retirement savings is that retirement savings that have been rolled over into an IRA are freely withdrawable by the IRA owner.<sup>262</sup> The rollover system must rely largely upon IRAs to hold transferred retirement savings, so ultimately the preservation of those savings until retirement is dependent solely upon the IRA owner's decision to continue to hold the savings in the IRA. Since the preservation of preretirement distributions as retirement savings is dependent on each participant's decision not to consume those savings, there is no reason to believe that the form of the rollover transfer, direct or actual, will influence the IRA owner's consumption and savings decisions.

#### D. *The Actual Rollover Should Be the Sole Form for Rollover Transfers*

The direct rollover form of transfer increases administrative costs for an employer-sponsored retirement plan, and these costs are likely to reduce the retirement benefits accruing to plan participants generally. The benefit of the direct rollover system is limited to providing increased certainty of compliance for those participants who choose to transfer their retirement savings in a direct rollover transfer. Moreover, it is also unlikely that the direct rollover system makes any contribution to enhanced preservation of preretirement distributions from retirement plans. Thus, the direct rollover system does not offer sufficient benefits to justify its costs. For that reason, the direct rollover provisions should be repealed and the actual rollover form of transfer should be left as the

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<sup>262</sup> Retirement savings that are rolled over into a qualified trust are also likely to be freely withdrawable by the participant. *See supra* note 171 and accompanying text.

sole means by which retirement savings can be transferred from a retirement plan to another form of retirement savings.

#### VIII. REVISIONS FOR THE ACTUAL ROLLOVER SYSTEM

If the actual rollover system were the exclusive method by which a distribution could be rolled over, it would be necessary to amend the provision requiring twenty percent withholding tax on an eligible actual rollover distribution to exempt from withholding the portion of a distribution a potential distributee certified she intended to roll over. It would also be desirable to amend the rollover provisions to grant the IRS authority to permit retroactive correction of inadvertent noncompliance with the rollover requirements in cases in which a distributee establishes reasonable cause.

##### *A. The Withholding Tax Exemption Should Be Extended to Actual Rollovers*

Under current law, a twenty percent withholding tax is collected from every eligible rollover distribution actually distributed to a distributee, even in cases in which the distributee subsequently actually rolls over her distribution.<sup>263</sup> If the actual rollover system were the sole method for rollover, the twenty percent withholding tax should be revised to permit a potential distributee who intends to roll over all or any portion of her eligible rollover distribution to file a withholding tax certificate establishing an exemption from the withholding tax for the portion of the distribution she intends to roll over. This revision would permit a distributee to receive the full amount of an eligible rollover distribution that she intended to transfer in an actual rollover. Receipt of the full distribution would eliminate the need that exists under the present structure for the distributee to replace the twenty percent withheld from the distribution with other funds in order for her to roll over an amount equal to the full amount of the distribution. It is important to permit a distributee to receive the full amount of her distribution so that she will be able to roll over that full amount and thereby preserve that full amount for retirement purposes. If the twenty percent withholding tax were not revised in this fashion, some distributees would not be able to supplement the eighty percent portion of their distribution with sufficient funds to transfer a rollover amount equal to the full distribution. This could result

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<sup>263</sup> See *supra* notes 70-73 and accompanying text.

in rollover transfers being reduced by amounts that are withheld, and this would result in a reduced level of retirement savings being preserved for retirement purposes. Exemption of the amount of a distribution that a potential distributee certifies will be rolled over would increase retirement savings.

*B. The IRS Should Be Granted Authority to Permit Correction of Attempted Rollovers*

The rollover provisions should be amended to grant to the IRS authority to permit certain distributees to correct inadvertent noncompliance with the rollover requirements after expiration of the sixty-day rollover period. The principal benefit of the direct rollover system is that it eliminates the risk for a distributee that she might fail to perfect her actual rollover transfer within the sixty-day period. There is no evidence that the problem of inadvertent noncompliance with the actual rollover requirements was widespread. If, in fact, inadvertent noncompliance occurs only occasionally, then the retirement plan system will be much better served by a system that addresses the specific cases of noncompliance, rather than by the imposition of the direct rollover system upon every retirement plan and a majority of retirement plan distributions.<sup>264</sup> Specific cases of noncompliance with the actual rollover requirements could be resolved by the IRS, without burdening most retirement plan distributions with compliance with the direct rollover requirements.

Authority to permit correction of an attempted rollover transfer could be exercised by the IRS if the following conditions were met:<sup>265</sup>

1. A retirement plan distributee received a distribution from a retirement plan;
2. The distributee attempted to comply with the actual rollover requirements;
3. The distributee subsequently learned that she failed to perfect her rollover transfer, and that this failure would cause her to incur additional tax liability;<sup>266</sup>

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<sup>264</sup> See *supra* note 245 and accompanying text.

<sup>265</sup> This proposed grant of authority to the IRS to permit a distributee to correct an imperfect rollover attempt is based upon the existing provision that permits the IRS to disregard an inadvertent termination of a corporation's election under subchapter S. See I.R.C. § 1362(f) (1994); Treas. Reg. § 1.1362-4 (as amended in 1992).

<sup>266</sup> For this purpose, the additional taxes should be income tax under I.R.C. § 1 or early distribution penalty tax under I.R.C. § 72(t).

4. Upon discovery of her failure to comply with the rollover requirements, the distributee promptly took reasonable steps to comply, or to seek a ruling that her failure was inadvertent;

5. The IRS determines that the distributee's failure to perfect her rollover transfer was inadvertent;

6. The distributee agrees to tax adjustments that the IRS may require for the periods during which the rollover requirements were not satisfied.

A distributee who desired to obtain permission to correct a failed rollover under this provision would file a request with the IRS for a ruling that would allow the completion of a proper rollover, or the correction of an otherwise inadvertently failed rollover.<sup>267</sup> Correction of the rollover would allow the taxpayer to thereafter continue to hold the assets involved in an IRA or a successor retirement trust. Except for income taxes on income earned during the period from receipt of the distribution until the correction of the rollover, the taxpayer would be treated as though the rollover had complied with the rules in the first instance.

#### 1. *Noncompliance Must Be Inadvertent*

The concept of an inadvertent failure to qualify for rollover treatment should include several types of mistakes. Even though a qualified plan administrator is required to give an explanation of the rollover rules to a distributee of a distribution that qualifies for rollover treatment,<sup>268</sup> sometimes plan payees fail to receive this information and simply do not know of the rollover alternative. Ignorance of the rollover possibility should qualify as inadvertence. In Letter Ruling 88-15-032,<sup>269</sup> the employer failed to notify the taxpayer that the rollover period was sixty days, and the taxpayer believed that a rollover could be made within ninety days after receipt of the distribution. The IRS ruled that it did not have authority to waive or grant extensions of the statutory period, so that the tax was imposed on the distribution. Revenue Ruling 87-77<sup>270</sup> discusses the attempt of a participant who received a distribution that included property other than money to deposit into an IRA money equal

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<sup>267</sup> The regulations implementing the subchapter S relief from inadvertent terminations of the S corporation election provide that the request for a determination of an inadvertent termination shall be made in the form of a ruling request. *See* Treas. Reg. § 1.1362-4(c).

<sup>268</sup> *See* I.R.C. § 402(f).

<sup>269</sup> Priv. Ltr. Rul. 88-15-032 (Jan. 19, 1988).

<sup>270</sup> Rev. Rul. 87-77, 1987-2 C.B. 115.

in value to the distributed property, while retaining the distributed property. The ruling holds that a tax-free rollover requires that the participant deposit the identical property that has been distributed or the proceeds of its actual sale. These types of innocent mistakes about technical rollover requirements should qualify as inadvertence. In Letter Ruling 77-47-081,<sup>271</sup> the taxpayer's employer erroneously informed the taxpayer that employer contributions included in a distribution and eligible for rollover were \$1666, and the taxpayer rolled over this amount. The employer later reported the correct amount of employer contributions to be \$3147. The ruling finds that there was no statutory basis for the IRS to permit the taxpayer to roll over the additional \$1481 after expiration of the sixty-day rollover period. Inadvertence also should encompass this type of reasonable reliance on apparently valid information supplied by a third party.

In *Wood v. Commissioner*,<sup>272</sup> the taxpayer delivered cash and stock to a brokerage firm with instructions that it was to be deposited into his rollover IRA. The brokerage firm's bookkeeping records indicated that the cash had been deposited to the IRA, but the stock was transferred to the taxpayer's regular brokerage account. Four months after expiration of the sixty-day rollover period, the brokerage firm made an adjusting journal entry to show that the stock was held by the IRA. The Tax Court disregarded the form of the original bookkeeping entries and held that the substance of the transaction was a tax-free rollover. Such a case, in which the taxpayer took all reasonable steps to comply with rollover requirements and it was solely the actions of a third party that caused noncompliance, should demonstrate inadvertence on the part of the taxpayer. From these cases, categories of inadvertence emerge: innocent mistakes of fact or law, and mistakes of third parties.

## 2. *Prompt Corrective Action*

The action to be taken with reference to a failed rollover may be of two types, either a direct correction of the noncomplying aspect of the rollover, or the filing of a request for a ruling which allows corrective action to be taken if, and after, a favorable determination is made by the IRS.<sup>273</sup> In some cases, it may be practical and prudent to correct the

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<sup>271</sup> Priv. Ltr. Rul. 77-47-081 (Aug. 26, 1977).

<sup>272</sup> *Wood v. Commissioner*, 93 T.C. 114 (1989).

<sup>273</sup> The relevant facts are when the taxpayer had, or reasonably should have had, information about noncompliance with rollover requirements, and how long

rollover promptly upon discovery of the noncompliance. In *Wood*,<sup>274</sup> the bookkeeping error could be corrected without any further transactions affecting the rollover assets, and had the courts failed to give relief, the taxpayer's income tax returns for the years during which the status of the rollover was being determined could be adjusted by the addition of the income earned by the putative rollover IRA. In other cases, it may not be possible for the taxpayer to correct the rollover until it is determined that the IRA will in fact be a valid rollover IRA. In cases involving a proposed deposit to an IRA after the sixty-day period, it would be prudent to obtain a ruling before establishment of the account because of the potential for excise taxes and ordinary income taxation of excess contributions to an IRA. A distributee who discovers that her attempted rollover is imperfect ought not be put to the dilemma of either risking the potentially confiscatory IRA penalty taxes or foregoing her opportunity to roll over her distribution. The IRS should permit the distributee to complete her corrective action after receipt of a ruling that her failure to comply with the rollover requirements was inadvertent.

### 3. *Agreement to Income Tax Adjustments*

The final proposed condition to the allowance of a retroactive correction of a failed rollover requires that the taxpayer agree to income tax adjustments consistent with the corrected treatment of the case. Most cases involving deposits after the sixty-day period would not call for income tax adjustments, since the taxpayer would have held the distributed assets in a taxable account until they were deposited into the rollover IRA. Assuming that most taxpayers would delay the IRA deposit until after a favorable ruling is obtained, there may be few cases in which income tax adjustments might be required.

### CONCLUSION

The dual rollover structure imposes additional costs upon retirement plan sponsors and participants. Little is gained, surely not enough to

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after that the taxpayer took action. This determination about timing of action will be exactly analogous to those made under the inadvertent termination requirement applicable to S corporations that "[s]teps [be] taken to return to small business corporation status within a reasonable period after discovery of the terminating event." Treas. Reg. § 1.1362-4(a)(3) (as amended in 1992).

<sup>274</sup> *Wood v. Commissioner*, 93 T.C. 114 (1989).



justify the costs of the system. The imposition of a withholding tax on an actual distribution that a participant intends to roll over is unjustified and anomalous. The direct rollover system attempts to enlist retirement plan administrators in the effort to preserve preretirement distributions for retirement purposes, yet this effort is ineffective without attention to the distribution provisions of the eligible retirement plans. This legislation is a reminder of the reasons not to attempt to teach a pig to fly: the lessons will be futile, and they surely will annoy the pig. Similarly, the direct rollover alternative accomplishes little, and it surely annoys the citizenry.